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Quarterly report and macroeconomic projections for the Spanish economy. June 2023

Contents

EDITORIAL

Editorial

Global economic activity has performed relatively favourably in 2023 to date. The positive developments in activity in the first half of the year include a significant easing of energy prices and a fading of the disruption in global value chains, as well as notably buoyant services, which have continued to reap the benefits of the return to normal following the end of the health crisis. Moreover, strong labour markets and national fiscal policy support have mitigated the impact of high inflation on household incomes and have helped sustain the strength of overall activity.

That said, some signs of weakness have also been discerned, especially in the most recent period. These signs have been particularly evident in manufacturing, at sector level, and, as regards geographical areas, in China and the euro area, where the latest available short-term indicators have been consistently surprising on the downside. Indeed, in the case of the euro area, the latest national accounts figures published by Eurostat point to a slight contraction in GDP in the first three months of the year, while the growth forecasts for the current quarter have been revised downwards in recent weeks. One possible explanation for these developments is the considerable monetary tightening that has occurred in recent quarters, both in the euro area and globally. This has entailed far tighter financing conditions in the economy as a whole, which already appear to be constraining the momentum of activity somewhat (given the speed at which the flow of new credit is slowing in certain countries, for example). However, the adverse effects on activity will foreseeably peak in the coming quarters.

Inflation has continued to ease in recent months, mainly as a result of the reduction in the energy component. Albeit unevenly across countries, the fall in energy commodity prices and the existence of significant base effects have contributed to these developments. However, the other components of inflation have only begun to show as yet incipient signs of moderation in certain jurisdictions.

The uncertainty surrounding the behaviour of non-energy inflation in the coming quarters remains elevated. Looking ahead, it seems likely that the reversal of the commodity price rises and the easing of bottlenecks will contribute to a reduction in non-energy industrial goods inflation. Likewise, food prices will conceivably also gradually slow over the coming months as a result of the reduction in production costs (although in some geographical areas unfavourable weather conditions may hinder this disinflation process). Services prices will foreseeably decelerate more slowly, for two reasons. First, the demand for tourism and leisure-related activities remains strong, and second, labour costs (which are still increasing gradually) usually account for a higher share of costs in services than in other sectors. In any event, there continues to be considerable uncertainty surrounding the intensity of these disinflation processes and the existence of possible asymmetries in the pass-through of intermediate input cost changes to consumer prices. Also, the persistence of high inflation rates may lead to the emergence of significant second-round effects on prices (through wages and/or profit margins), which could compound current price pressures.

The Spanish economy has displayed notable resilience in the first half of the year. In 2023 Q1, Spanish GDP grew by 0.5% (as against a decline of 0.1% in the euro area). The strength of the Spanish economy was underpinned, among other factors, by the recovery in tourism activity and the buoyancy of exports of other non-tourism services. This elevated buoyancy has extended into Q2. However, towards the end of the quarter certain signs of slowdown have been discernible that, as at the global level, are possibly a manifestation of tighter financing conditions as a result of the monetary tightening in the euro area needed to bring down inflation.

Over the course of the year the rate of change of consumer prices has fallen very sharply in Spain. This decrease, which has principally affected the energy component, has been more pronounced than in the euro area, partly because of the regulations that determine how retail electricity prices are set in Spain. In any event, in recent months the easing of inflationary pressures appears to have begun to be passed through gradually to the rest of consumer prices.

GDP is expected to grow by 2.3% in 2023. As detailed in the final section of this report, which contains the latest Banco de España macroeconomic projections, weaker price pressures and a potential acceleration in the execution of Recovery and Resilience Facility-related projects, among other factors, will help Spanish economic activity continue to grow over the rest of the year. The annual average growth rates projected for 2024 (2.2%) and 2025 (2.1%) are very similar to the 2023 rate. However, output growth will mainly be underpinned by the recovery in private consumption, and less so by the contribution of net external demand, the main driver of growth in 2023.

The recent deceleration in underlying inflation will continue in the coming months. Underlying inflation is expected to run at 4.1% in 2023, before declining to 2.1% in 2024 and 1.7% in 2025. Meanwhile, headline inflation is expected to average 3.2% this year. In 2024 it will increase to 3.6%, mainly as a result of the expected withdrawal of most of the measures deployed by the authorities to combat the effects of the rise in inflation, which will cause the rate of growth of the energy component to accelerate. Nevertheless, under the projection exercise's assumptions, headline inflation will resume its downward path in 2025, decelerating to 1.8%.

The uncertainty surrounding the Spanish economy's macroeconomic outlook in the short and medium term remains very high. Foremost among the different sources of uncertainty are the difficulties in assessing how strong an impact the monetary tightening to date may have on GDP growth, price developments and financial markets, as, from a historical perspective, the current episode of monetary policy tightening is particularly unique in several respects. Specifically, it has been very swift and synchronised across different jurisdictions and has taken place after almost a decade of highly accommodative monetary policy. Other very important sources of uncertainty include the course of the war in Ukraine and the possible emergence (in Spain and/or in the euro area as a whole) of significant second-round effects on inflation that might require monetary policy tightening beyond the financial markets' current expectations. With regard to the latter, the fifth Employment and Collective Bargaining Agreement that Spain's main social partners recently reached includes recommendations for wage settlements for the period 2023-2025 that make second-round effects via wages slightly less likely in Spain.

REPORT

1 Global economic activity gained traction over the first months of 2023, driven by the highly buoyant services sectors

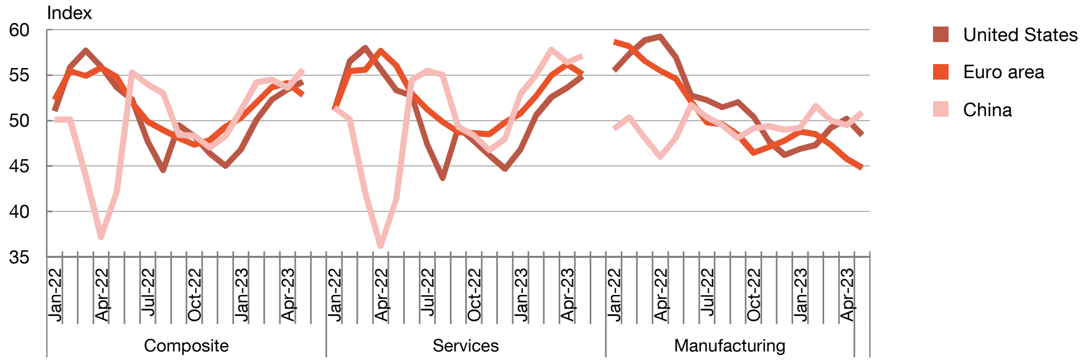
— Over the last few months, in a setting of relative sluggishness in manufacturing, the considerable buoyancy of services (see Chart 1.a) appears to be related both to the persisting positive impact of the post-pandemic reopening of the economy on demand in the most social-intensive sectors of activity and to the strong growth in information and communication activities and in professional services associated with the digital transformation process.

— Among the main world economies, in the United States the performance of employment continues to surprise on the upside, although activity slowed in the first quarter. In China, the end of the zero-COVID policy in late 2022 seems to have boosted activity more than expected in the first months of 2023, although the latest conjunctural indicators point to a slight slowdown.

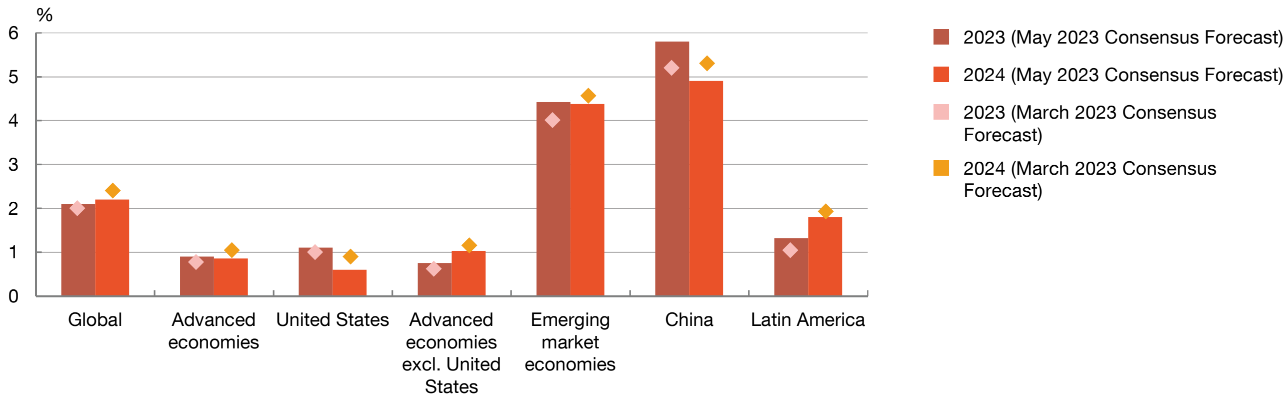
— Overall, these developments have recently prompted a slight upward revision of analysts' growth forecasts for 2023, especially in China (see Chart 1.b), and a slight downward revision for 2024, in view of persistent inflation and restrictive financial conditions.

Chart 1

1.a Purchasing Managers' Indices



1.b GDP growth forecasts, by geographical area (a)



SOURCES: Bloomberg, Consensus Forecast and S&P Global.

a Consensus Forecast projections (bars: May; diamonds: March). "Advanced economies" comprises 13 geographical areas: Canada, Czech Republic, Denmark, euro area, Iceland, Israel, Japan, Norway, South Korea, Sweden, Switzerland, United Kingdom and United States. "Emerging market economies" comprises 13 economies from Asia, eastern Europe and Latin America: China, India, Indonesia, Malaysia, Thailand, Hungary, Poland, Russia, Brazil, Chile, Colombia, Mexico and Peru.

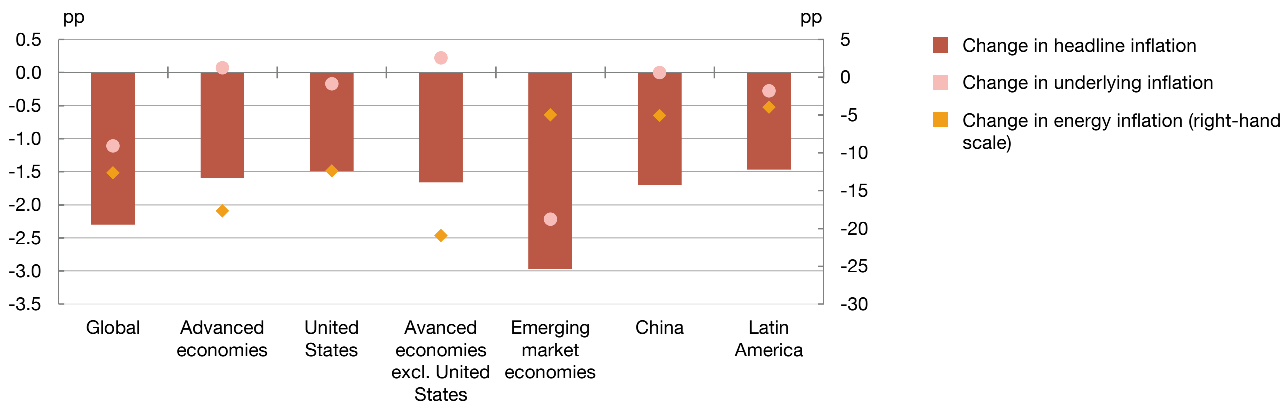
2 Headline inflation rates have prolonged their global moderating path, although as yet there has been no widespread downward shift in underlying inflation

— In recent months the decline in energy prices has continued to contribute to reducing global headline inflation rates. However, there has been no significant or widespread downward shift in underlying inflation rates, except in certain emerging market economies (see Chart 2.a).

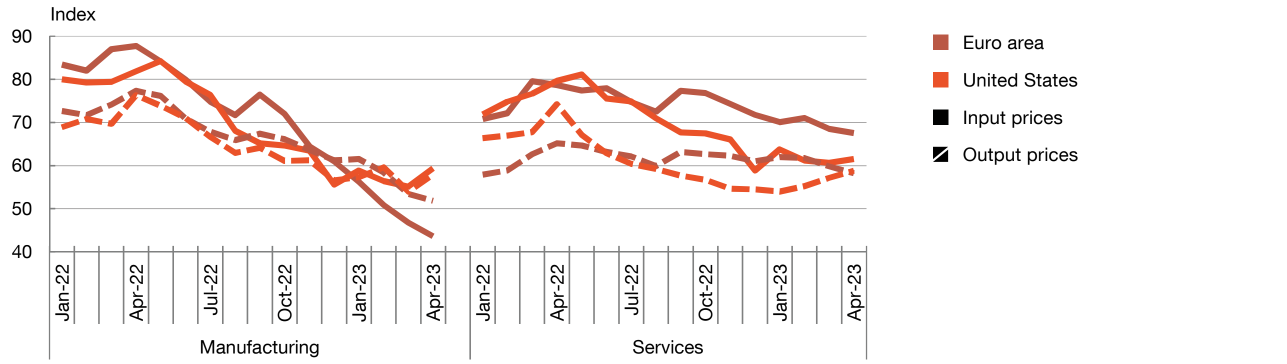
— Changes in prices are highly uneven by sector of activity (see Chart 2.b). On the one hand, the normalisation of global supply chains and the lower commodity prices have been conducive to a relatively strong slowdown in manufacturing prices in recent months. On the other, the recent strength in demand for services has meant that inflation has eased less in these sectors of activity, even increasing in some geographical areas.

Chart 2

2.a Change in headline and underlying inflation between December 2022 and April 2023 (a)



2.b Price indicators (PMI)



SOURCES: National statistics and S&P Global.

a "Global" comprises China, Czech Republic, euro area, Hong Kong, Hungary, India, Indonesia, Japan, Malaysia, Russia, Singapore, South Korea, Taiwan, Thailand, Turkey, United Kingdom and United States, as well as "Latin America" (comprising Brazil, Chile, Colombia, Mexico and Peru). "Advanced economies" comprises Canada, euro area, Japan, Norway, Sweden, Switzerland, United Kingdom and United States.

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3 The main central banks have reduced the pace of their monetary policy tightening

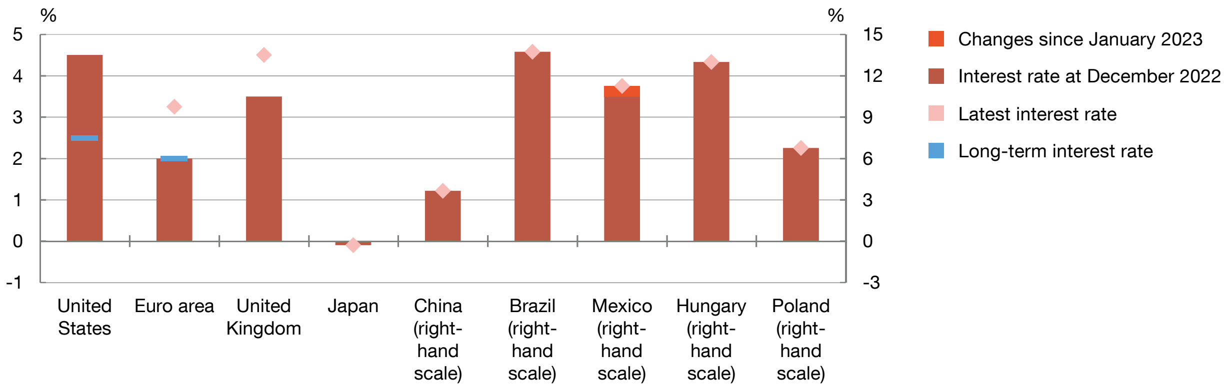
— For instance, the European Central Bank, which raised its policy interest rates by 50 basis points (bp) at its monetary policy meetings of December 2022 and February and March 2023, raised them by 25 bp at its latest two meetings in May and June 2023.

— A similar slowdown has also been seen in most developed economies' central banks, such as the Bank of England and the US Federal Reserve, which have also reduced the pace of policy rate hikes to 25 bp at their latest meetings.

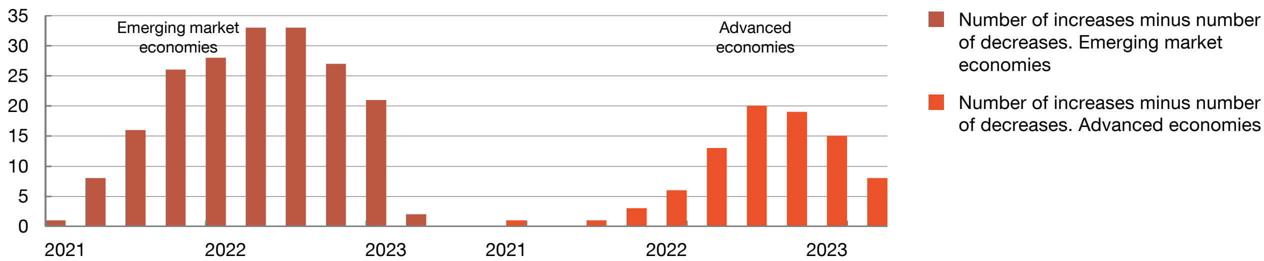
— Against this backdrop, in which policy interest rates are in restrictive territory in the world's main economies (see Chart 3.a) and the pace of further global monetary policy tightening has slowed significantly (see Chart 3.b), analysts' focus has begun to shift to when the first policy rate cuts might take place in certain regions.

Chart 3

3.a Policy interest rates



3.b Global monetary policy tightening decisions (a)



SOURCES: National central banks and Refinitiv.

a "Advanced economies" comprises 11 geographical areas: Australia, Canada, Denmark, euro area, Japan, New Zealand, Norway, Sweden, Switzerland, United Kingdom and United States. "Emerging market economies" comprises 23 economies from Asia, eastern Europe and Latin America: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Kazakhstan, Malaysia, Mexico, Peru, Philippines, Poland, Romania, Russia, South Africa, South Korea, Thailand, Tunisia, Turkey and Ukraine.

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4 International financial markets have recently been influenced by smaller policy interest rate increases and easing banking sector stress

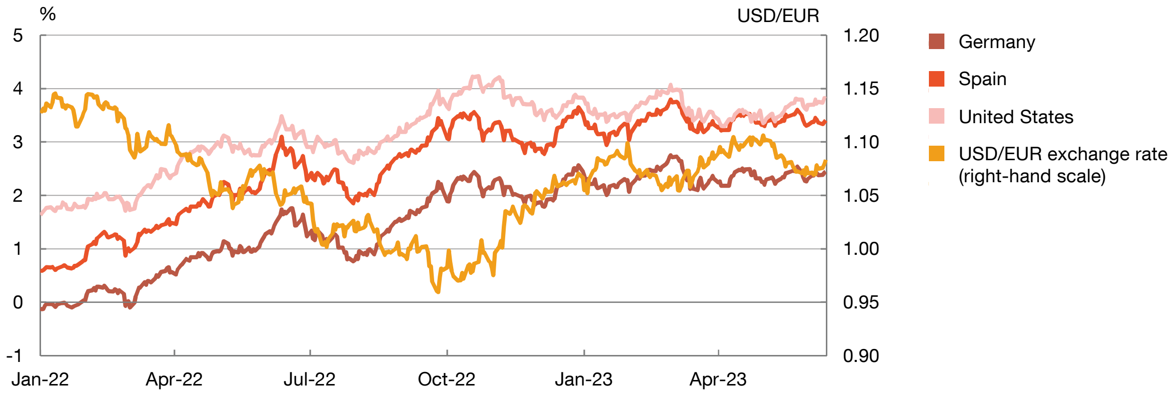
— Long-term sovereign bond yields have proven less volatile in recent months than during 2023 Q1, but they have increased slightly since the end of March. For instance, the yields on Spanish and German ten-year bonds have risen by 8 bp (to 3.4%) and 14 bp (to 2.4%), respectively, in Q2 to date (see Chart 4.a).

— The main international stock market indices have recorded slight gains in Q2; however, the bank indices have not yet recovered the levels recorded prior to the financial turbulence in March (see Chart 4.b), largely because of some uncertainty persisting over developments at US regional banks.

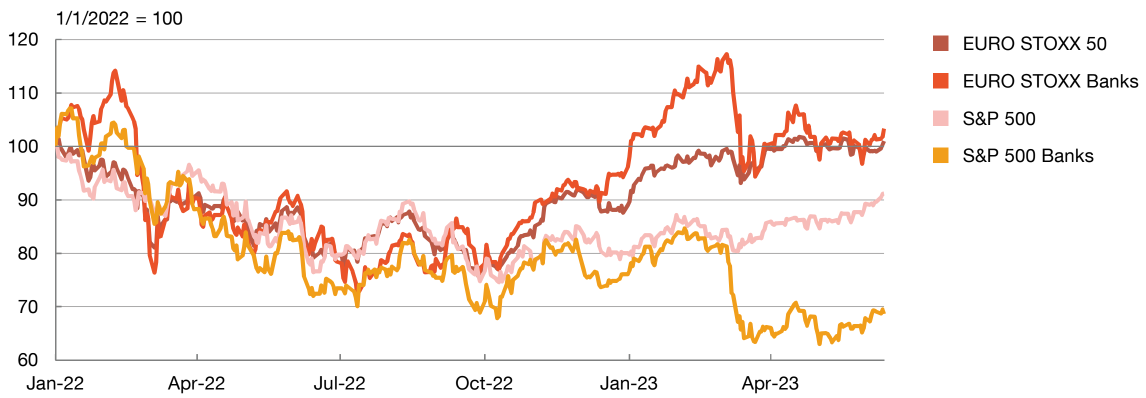
— On the foreign exchange markets, the euro has fluctuated between appreciating and depreciating slightly against the US dollar, with the USD/EUR exchange rate mainly unchanged in Q2 to date. However, the euro has appreciated against the dollar by over 11% since September 2022, when it was below parity.

Chart 4

4.a Ten-year sovereign bond yields and exchange rate



4.b Stock market indices



SOURCES: Refinitiv and Datastream.

5 In the euro area, economic activity has picked up somewhat in recent months, after falling slightly in previous quarters

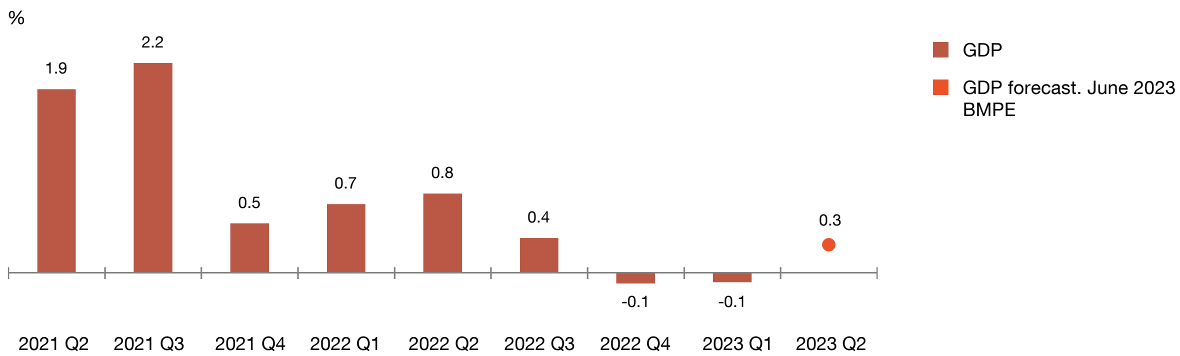
— After two quarters in which euro area GDP contracted slightly, the latest short-term economic indicators point, overall, to positive quarter-on-quarter growth of around 0.3% in Q2, according to the June Eurosystem projection exercise (see Chart 5.a).

— However, the latest information suggests that the pace of growth of output in Q2 will be slightly slower than expected a few weeks ago. In addition, persistent high inflation and the monetary tightening process launched at the end of 2021, whose full effects on activity may lag by 18-24 months (Banco de España, 2023), point to the pace of growth of euro area GDP slowing slightly in 2023 H2.

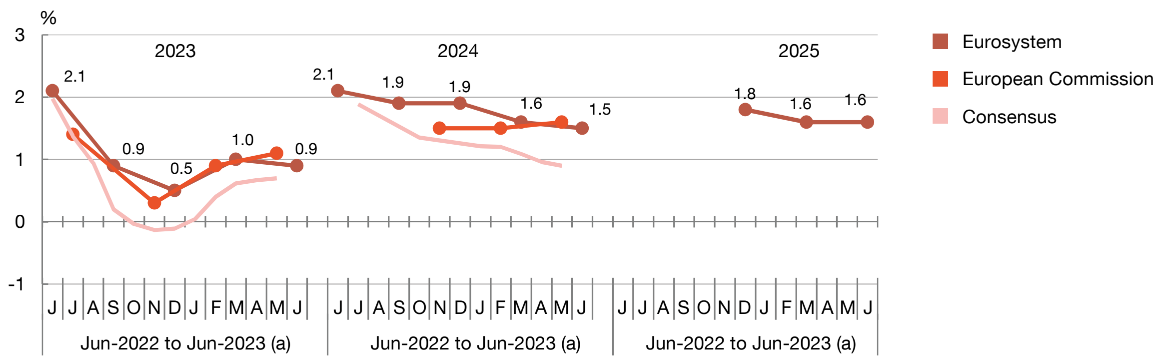
— As a result, the June Eurosystem projection exercise forecasts euro area GDP growth of 0.9% in 2023 and 1.5% in 2024 (a downward revision of 0.1 percentage points (pp) to the March projection for both years), while the growth forecast for 2025 remains practically unchanged (see Chart 5.b).

Chart 5

5.a Euro area. GDP (quarter-on-quarter rate of change)



5.b Euro area. GDP growth forecasts



SOURCES: European Commission, Consensus Economics, Eurosystem and Eurostat.

a Each letter refers to the month in which the corresponding forecast was published.

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6 Despite continuing to fall, euro area inflation remains high because of the momentum of food and services prices

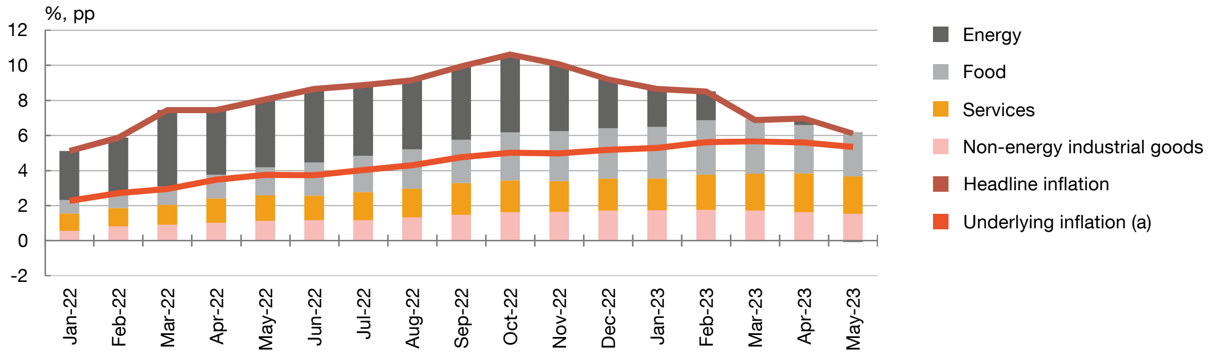
— Headline inflation continued to fall, to 6.1%, in the euro area in May (see Chart 6.a). Unlike in most of 2022, the energy component made practically zero contribution to these inflationary pressures, which remain very high. Meanwhile, the food and services contributions have barely budged from their recent all-time highs. In this respect, underlying inflation (which reflects changes in the prices of non-energy industrial goods and services) ran at 5.3% in May, down just 0.4 pp from its March peak.

— The future path of inflation is highly uncertain and depends on opposing forces. Lower energy prices, fading bottlenecks and the appreciation of the euro would make imports less expensive and lower imported inflation. Meanwhile, buoyant activity, especially in the services sectors, and the momentum of profit margins and wages could drive up domestic inflationary pressures.

— In light of this, compared with the March projections, the June Eurosystem projection exercise has revised up the average inflation rates forecast for 2023, from 5.3% to 5.4% for headline inflation and from 4.6% to 5.1% for underlying inflation. The current inflationary pressures are expected to gradually ease over the rest of the projection horizon (to 3% in 2024 and 2.2% in 2025, in the case of headline inflation), in line with the March projections.

Chart 6

6.a Euro area inflation and contribution of the components



SOURCE: Eurostat.

a HICP excluding energy and food.

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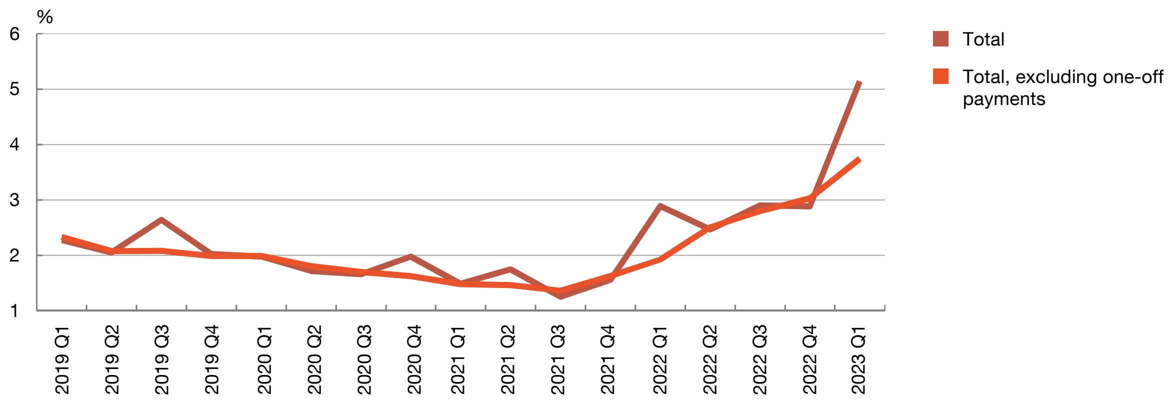
7 The uncertainty surrounding the euro area growth and inflation projections is very high and owes to external and domestic factors alike

— On the external side, the main sources of uncertainty are related to the course of the current geopolitical tensions – especially those associated with the war in Ukraine – and how the swift and sharp tightening of monetary policy worldwide could affect macroeconomic aggregates and international financial markets.

— On the domestic front, the possibility of significant second-round effects via wages and profit margins represents an upside risk to the inflation projections and a downside risk to growth, particularly against the backdrop of a still-strong euro area labour market (see Chart 7.a) and demand that continues to prove considerably resilient in certain sectors. Likewise, the reform of the European fiscal governance framework, and its impact on the fiscal policy stance of the different Member States in the coming years, also represents a significant element of uncertainty for the euro area medium-term growth and inflation projections.

Chart 7

7.a Euro area wage settlements. Year-on-year rates of change



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SOURCES: ECB and European Commission.

8 The ECB has continued to raise its key interest rates to ensure that inflation returns to its 2% medium-term target

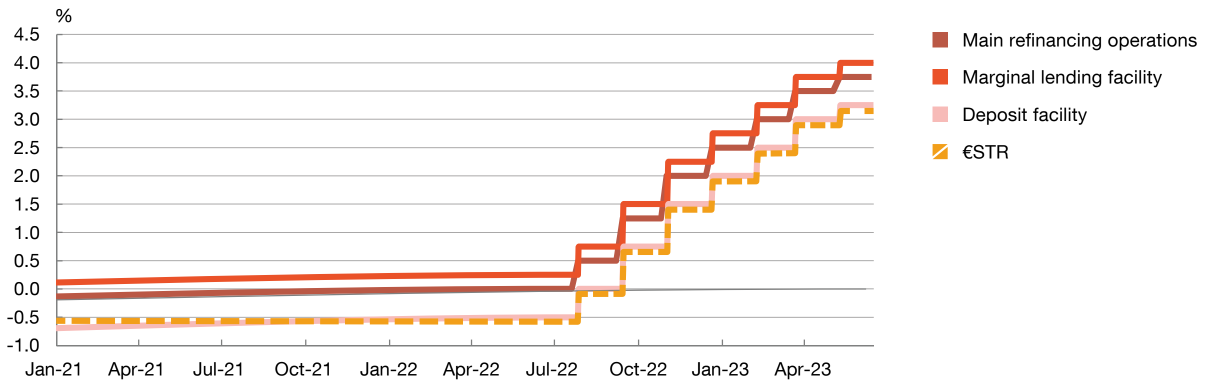
— Euro area inflation has declined, but the Eurosystem staff macroeconomic projections indicate that it will remain too high for too long. In consequence, the ECB's Governing Council has continued its monetary policy tightening. At its June meeting, the Governing Council raised its key interest rates by 25 bp, taking the deposit facility rate to 3.50%.[1] This means a cumulative increase of key ECB interest rates of 400 bp since July 2022 (see Chart 8.a).

— Going forward, the Governing Council will continue to follow a data-dependent approach. In particular, its interest rate decisions will continue to be based on its overall assessment of three aspects: (i) the inflation outlook in light of the incoming economic and financial data, (ii) the dynamics of underlying inflation and (iii) the strength of monetary policy transmission.

— Further, in line with the announcement at its May meeting, the Governing Council has confirmed in June that it will discontinue the reinvestment of the principal payments from maturing securities under the asset purchase programme (APP) as of July 2023. This decision, which will further reduce the size of the Eurosystem balance sheet, contributes to tightening financing conditions and therefore compliments the interest rate increases.

Chart 8

8.a Key ECB interest rates and €STR



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SOURCES: Banco de España and Refinitiv Datastream. Latest data: 15/06/2023

1 With effect from 21 June 2023.

9 In Spain, GDP growth was stronger than expected in 2023 Q1 owing to the contribution of net external demand

— In 2023 Q1, Spanish GDP grew by 0.5% quarter-on-quarter, slightly more than forecast in the Banco de España's March projection exercise and than recorded in 2022 Q4. In addition, as per the Quarterly National Accounts (QNA) flash estimate published by the National Statistics Institute (INE) in late April, a data review meant higher quarter-on-quarter growth rates for the last three quarters of 2022 (see Chart 9.a).

— According to the INE flash estimate, GDP growth in 2023 Q1 owed to the contribution of net external demand (1.3 pp), with domestic demand detracting -0.8 pp, as dynamism in investment failed to offset the decline in private consumption.

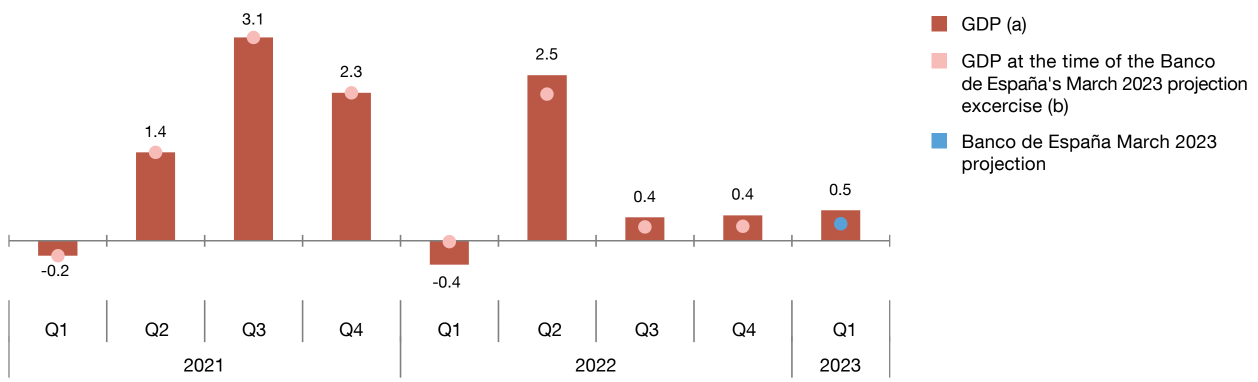
— On the supply side, the most buoyant sectors of activity in 2023 Q1 were those linked to the primary sector and to trade, transport and hospitality. Financial and insurance activities recorded the sharpest declines, while the industrial sectors performed somewhat sluggishly.

— As a result of these developments, in 2023 Q1 Spanish GDP stood 0.2% below its end-2019 level. By way of comparison, in that same quarter, overall euro area GDP exceeded its end-2019 level by 2.2%.

Chart 9

9.a Spanish GDP

Quarterly rate of change, %



SOURCES: Banco de España and INE.

a Latest series published by the INE (28 April 2023).
b Latest GDP series available (27 January 2023) at the time of the Banco de España's March 2023 projection exercise. Subsequently, on 24 March, the INE published its second QNA estimate for 2022 Q4 with a quarterly GDP path that was largely unchanged relative to the series published on 27 January.

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10 On balance, the latest short-term economic indicators suggest that economic growth in Spain may have accelerated slightly in Q2

— The various available indicators, which provide partial, and as yet incomplete, information on activity in 2023 Q2, suggest that Spanish GDP could grow in this period by around 0.6% quarter-on-quarter. However, there is considerable uncertainty surrounding this estimate.[2]

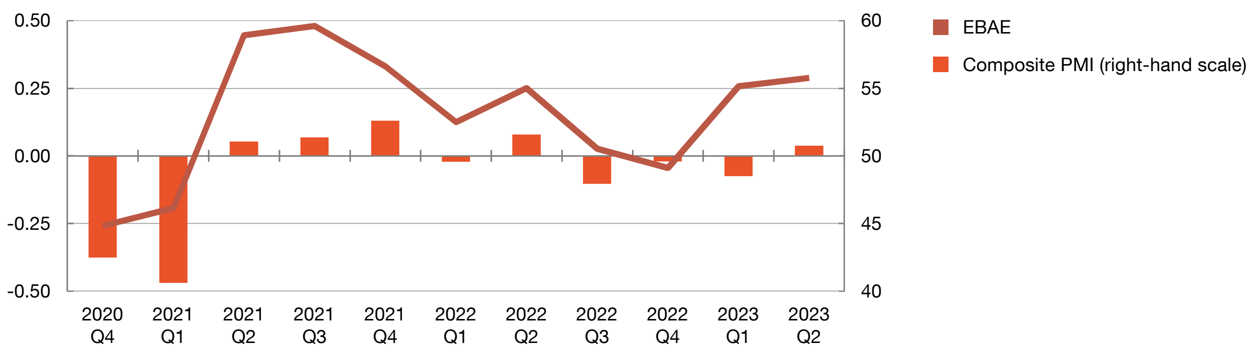
— Of note among the indicators consistent with more buoyant activity in Q2 are confidence indicators. For example, average PMI levels in April and May were higher than in the first three months of the year (see Chart 10.a), especially in the services sector.

— The results of the Banco de España Business Activity Survey (EBAE) point in the same direction, with Spanish firms reporting faster turnover growth in Q2 than in Q1.[3]

— However, some of the most recent indicators (for example, those relating to job creation) point to a certain moderation of activity in the final stretch of Q2.

Chart 10

10.a EBAE turnover and composite PMI (a) (b)



SOURCES: EBAE (Banco de España) and S&P Global.

a The qualitative responses from the EBAE are converted into a numerical scale as follows: significant decrease = -2; slight decrease = -1; stability = 0; slight increase = 1; significant increase = 2.
b The composite PMI figure for 2023 Q2 is the average in April and May.

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2 For more details, see the Projections in this report.

3 For more details, see Fernández Cerezo and Izquierdo (2023).

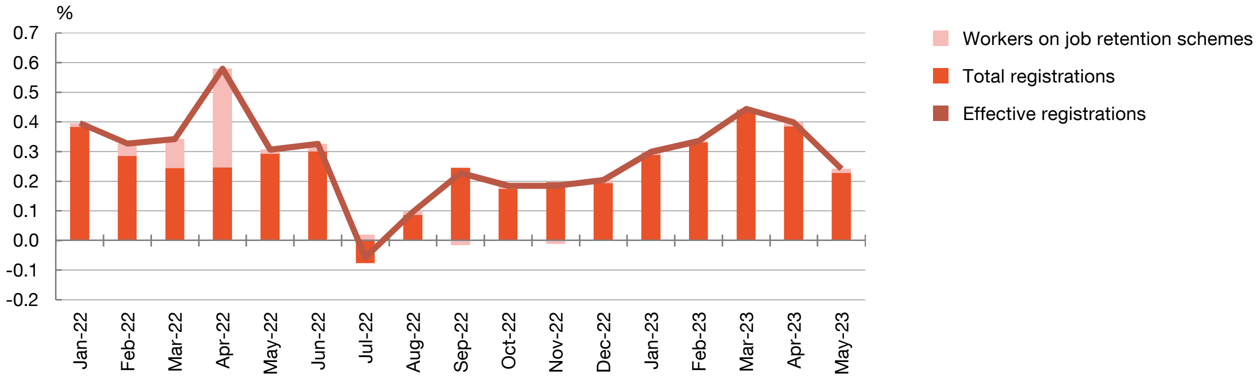
11 Job creation has remained very buoyant in recent months, especially in certain services sectors

— Social security registrations increased in seasonally adjusted terms by 0.4% in April and 0.2% in May (see Chart 11.a). Taking into account these increases and the trend in social security registrations during the first half of June, which points to a weaker job creation performance, in line with that seen in the second half of May, the quarter-on-quarter growth rate is expected to stand slightly above the 0.9% recorded in Q1.

— This strong employment performance can be seen across all sectors of activity. However, the recent vigour in employment is particularly noteworthy in services sectors linked to tourism, information and communications, and professional, scientific and technical activities. Some of these sectors are already seeing labour supply shortages which would at least partly explain the cross-sector differences in negotiated wage increases for 2023.

Chart 11

11.a Total social security registrations, workers on job retention schemes and effective social security registrations (a)



SOURCES: Ministerio de Inclusión, Seguridad Social y Migraciones and Banco de España.

a Seasonally adjusted monthly rate.

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12 The gradual tightening of bank lending conditions in Spain has continued

— The pass-through of the increase in market interest rates to the cost of new lending has continued to intensify in recent months (see Chart 12.a), although in the housing segment this process has been slower than in previous episodes of monetary tightening (Banco de España, 2023).

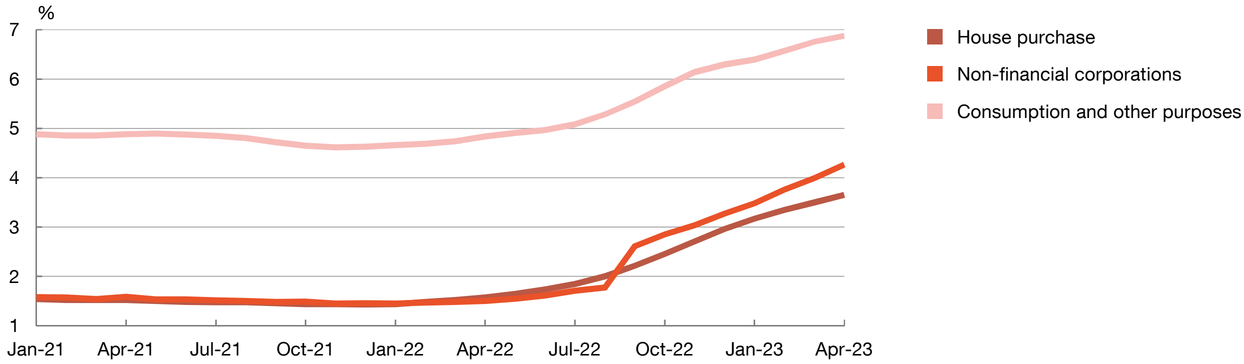
— The cost of loans for house purchase and business loans in Spain is similar to that in the euro area, while in the case of loans for consumption and other purposes the cost in Spain is higher than the euro area average, although the gap has narrowed in the most recent period.

— Meanwhile, according to the Bank Lending Survey, in 2023 Q1 credit standards and the terms and conditions applied to new loans tightened across the board for the fourth consecutive quarter. Also, the demand for credit saw a decline across all segments, which was particularly sharp in the case of loans for house purchase. For 2023 Q2, banks anticipate a further contraction in the supply and demand for credit.

— These dynamics have continued to translate into a contraction in the volume of new funding raised by households (especially for house purchase) and, to a lesser extent, by firms.

Chart 12

12.a Cost of new bank loans (a)



SOURCE: Banco de España.

a Bank interest rates are narrowly defined effective rates (NDERs) and are adjusted seasonally and for the irregular component.

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13 Private consumption appears to have recovered slightly during Q2, following the declines recorded in the previous quarters

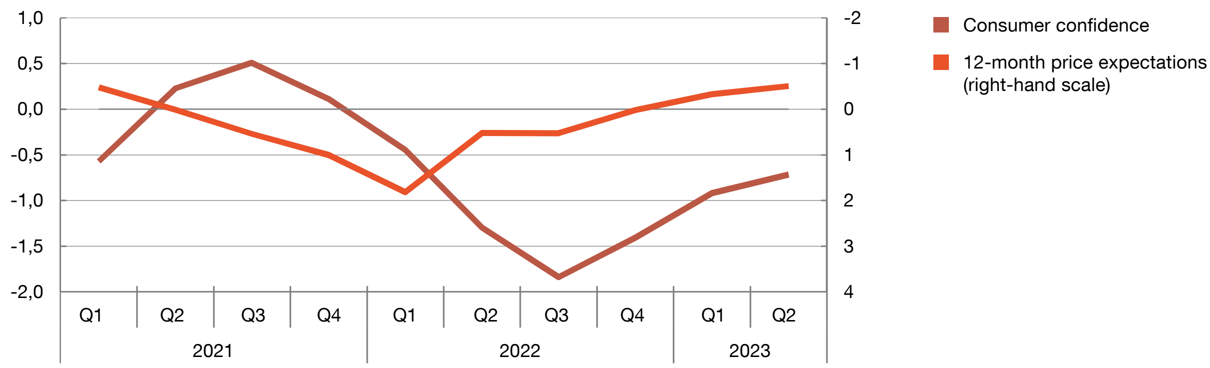
— Private consumption contracted in the first three months of 2023, weighed down by households' loss of purchasing power during the current inflationary episode and the adverse impact of the tighter bank lending conditions on their ability to spend (especially in the case of the most indebted households).

— However, in the second quarter to date, various factors point to more buoyant household consumption than in Q1, although it would remain somewhat subdued. Particularly notable are the strength of employment, the gradual improvement in confidence indicators and the prospect of a gradual easing of price pressures (see Chart 13.a), which will halt the deterioration in the purchasing power of wages and help shore up household confidence.

— That said, in the coming quarters the rate of expansion of household spending will continue to be constrained by more restrictive financial conditions and persistently high prices. Also, the rise in interest rates and the cost of debt may encourage households to devote more of their income and the savings they built up during the pandemic to loan repayment (Alves and Martínez-Carrascal, 2023).

Chart 13

13.a Household spending-related indicators (standardised data) (a)



SOURCES: European Commission and Banco de España.

a Latest available observation: May 2023.

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14 Business investment regained momentum in the first quarter and looks to have continued along an upward path in recent months

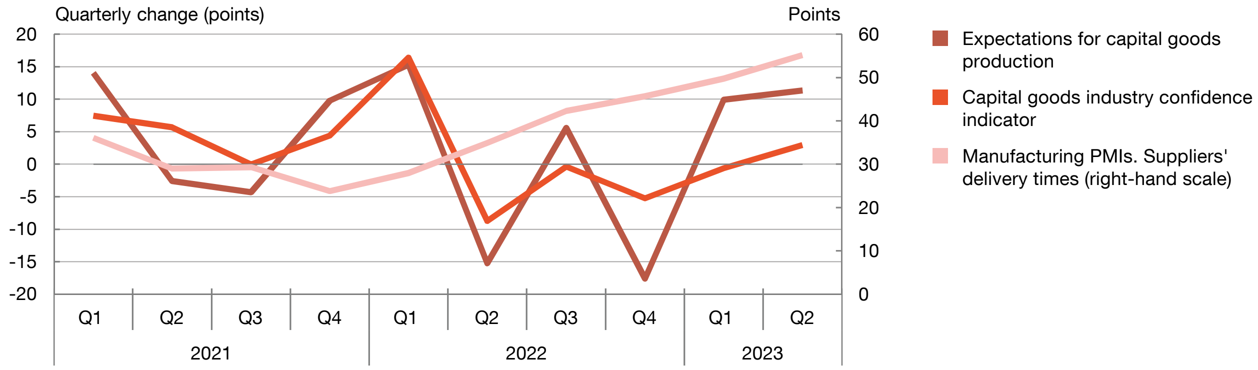
— Following its marked weakness in the last stretch of 2022, business investment regained considerable momentum in the first three months of 2023, partly driven by lower energy prices (and thus lower production costs) and by shorter suppliers' delivery times (as the supply chain bottlenecks eased). This helped lead to a gradual improvement in confidence indicators.

— A continuation of these patterns in recent months, together with the slow but steady roll-out of the Next Generation EU (NGEU) projects, seems to suggest that business investment continued to recover in 2023 Q2 (see Chart 14.a).

— However, similarly to household consumption, business investment will foreseeably remain constrained in the coming quarters by further monetary policy tightening, its impact on firms' financing conditions and persistently high levels of uncertainty.

Chart 14

14.a Industrial confidence indicators (a)



SOURCES: S&P Global and European Commission.

a Latest available observation: May 2023.

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15 As in previous quarters, housing investment appears to have been quite sluggish in Q2, weighed down by both supply and demand-side factors

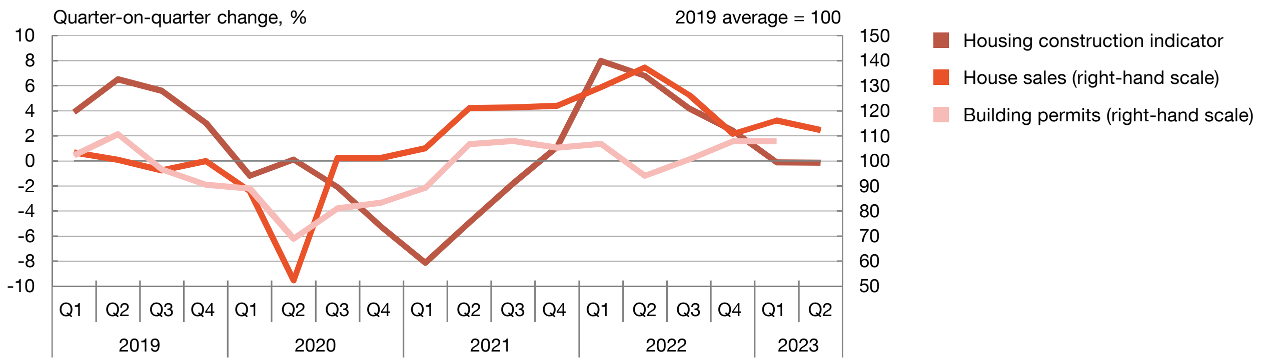
— On the supply side, the high costs of certain house building materials, labour shortages and the gradual tightening of financing conditions in the sector seem to be continuing to weigh on housing investment (San Juan, 2023). Nevertheless, building permits appear to have remained quite steady in the opening months of the year (see Chart 15.a).

— On the demand side, the tighter financing conditions facing households also look to have had a significant impact on housing investment in recent quarters, although house sales have shown considerable resilience since the start of the year (see Chart 15.a).

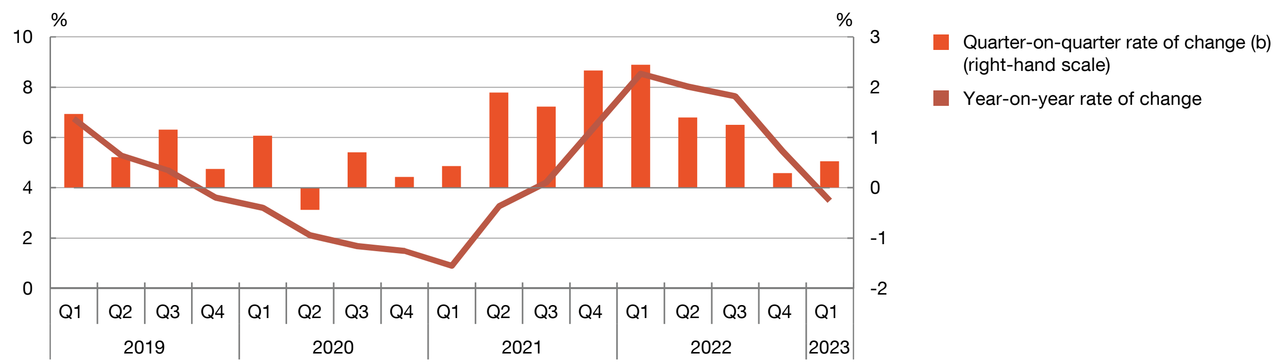
— The rate of growth of house prices moderated in Q1, down from 5.5% year-on-year in 2022 Q4 to 3.5%, an increase of 0.5% in quarterly terms (see Chart 15.b).

Chart 15

15.a Housing construction indicator, house sales and building permits (a)



15.b House prices



SOURCES: Banco de España, Centro de Información Estadística del Notariado, INE and Ministerio de Transportes, Movilidad y Agenda Urbana.

a For the housing construction indicator, the time frame considered is three months from issue of the building permit to the construction start date and 18 months thereafter for the construction work. Seasonally adjusted series for house sales. The latest observed data for house sales correspond to April 2023; the seasonally adjusted value is taken to represent 2023 Q2 as a whole.
b Calculated using the seasonally adjusted series.

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16 The foreign sector appears to have continued contributing positively to GDP growth in recent months, thanks to robust services exports and some competitiveness gains

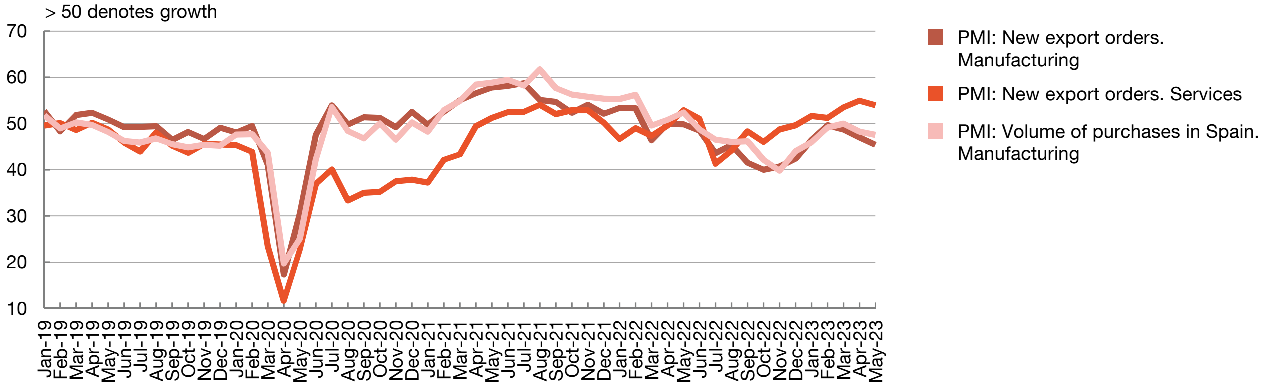
— In the early months of the year, the marked buoyancy in travel and non-travel services exports stood in contrast to the deceleration of goods exports. These movements seem to have continued throughout Q2, according to the May PMI for new export orders (see Chart 16.a).

— Meanwhile, the wage slowdown and more marked moderation of prices in Spain relative to the rest of the euro area recently appear to have led to improvements in the Spanish economy's competitiveness against its main trading partners. This can be seen, for instance, in competitiveness indicators based on unit labour costs (ULCs) and in consumer prices in comparison with the euro area (see Chart 16.b).

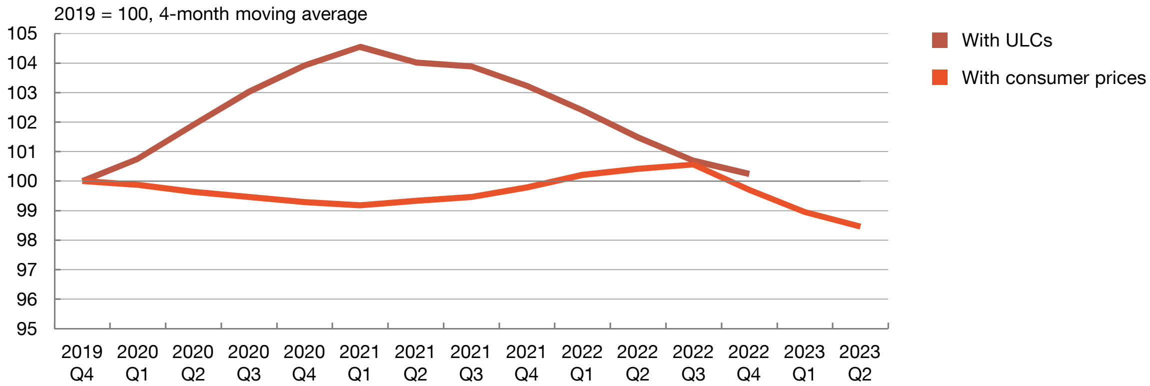
— In any event, in Q2 imports (which have seen a great deal of volatility in previous quarters) can be expected to be underpinned to a certain extent by strong capital goods investment. This would smooth net external demand's positive contribution to GDP growth in the quarter in comparison with Q1.

Chart 16

16.a Purchasing Managers' Indices



16.b Competitiveness indicators in Spain compared with the euro area (a)



SOURCES: Markit and ECB.

a Increases (decreases) of the indices reflect competitiveness losses (gains). Data as at May for 2023 Q2.

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17 The public sector may continue to underpin activity

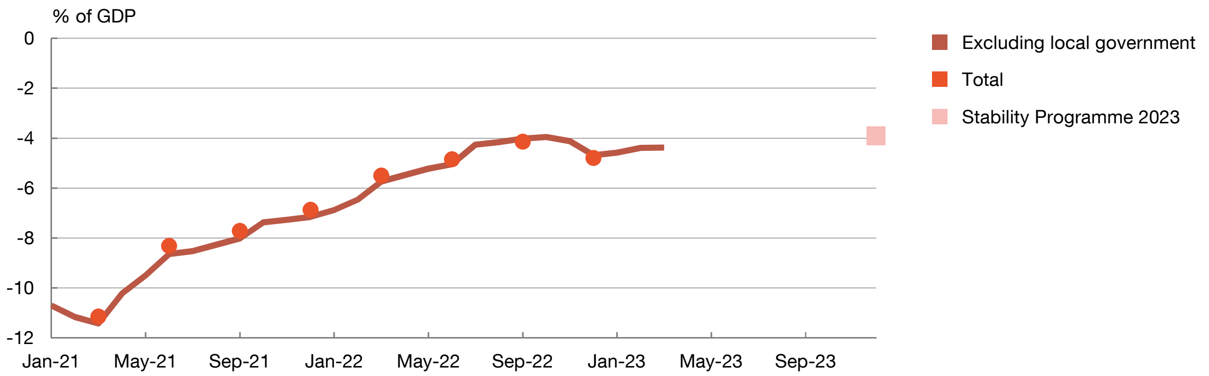
— A great deal of the support measures put in place to address the energy crisis were extended into 2023 and this, together with the increases approved for public sector wages and pensions and the roll-out of funding from the NGEU programme, appear to have led to an increase in government spending in recent months that more than offsets the increased receipts arising from the new taxes approved.[4] All of the above seems to have resulted in the public sector providing a broad-based boost to activity in the most recent period.

— However, as the stimulus provided by the NGEU programme has no impact on the general government balance,[5] the impulse will only be partially reflected in the public accounts. The 12-month cumulative general government balance appears to have improved slightly in 2023 Q1, rising by 0.4 pp, from -4.8% of GDP at end-2022 to -4.4% in March (see Chart 17.a).

— The recovery in revenue, which was the result of increased buoyancy in activity, the new taxes and the growth of other forms of revenue (mainly interest and dividends), provided a further boost. On the expenditure side, the uptick in social welfare benefits was noteworthy, rising 8.5% over the previous year's levels.

Chart 17

17.a General government balance (a)



SOURCES: Banco de España and IGAE.

a The IGAE only provides information on the overall general government sector quarterly.

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4 Mainly the increases in social security contributions, the new taxes on the financial sector, energy sector and wealth, and the new plastics and waste taxes. The combined impact of these measures on government revenue in 2023 is estimated to be around 0.6 pp of GDP.

5 Convention dictates that financial outlays of the NGEU programme are recorded at the same time as the corresponding receipt of the funds, such that there is no net impact on the general government balance.

18 Headline inflation continues to ease, owing to the energy component, while more recent months have seen early signs of a slowdown in food prices and underlying inflation

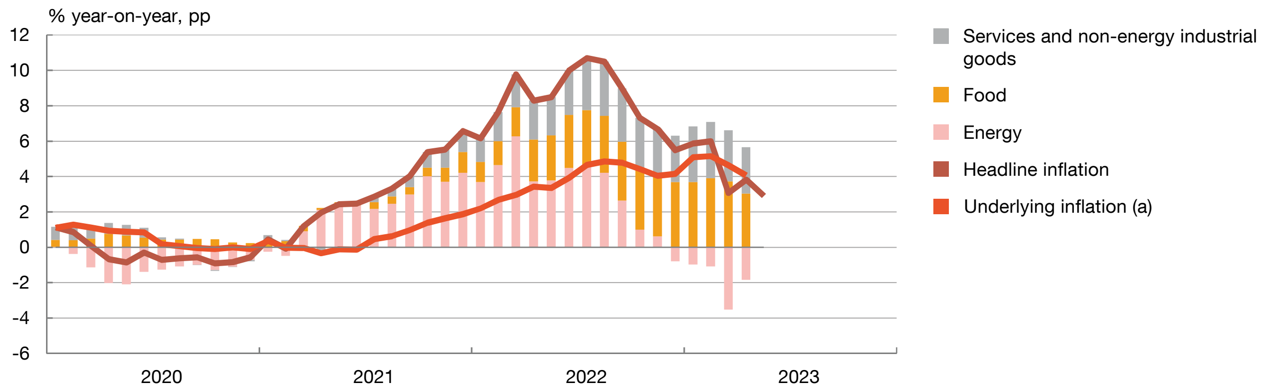
— Inflation in Spain stood at 2.9% in May – lower than expected and below the inflation rate recorded in the euro area –, down 7.8 pp on the July 2022 peak of 10.7% (see Chart 18.a).

— Until now, this correction has essentially been underpinned by the slowdown in energy prices. Nonetheless, Q2 so far appears to have seen the beginning of a slight downward trend in both food prices (particularly marked in the case of oil, bread and cereals, and dairy products) and underlying inflation (e.g. in the case of transport and, more recently, housing, recreation, hospitality and tourism).

— In any event, looking ahead, various factors could lead to a degree of downward stickiness in terms of the current inflationary pressures.[6] Such factors notably include, e.g. possible asymmetries in the way energy price variations pass through to consumer prices (in other words, falling energy costs pass through more slowly than rising energy costs), the drought that currently poses an upside risk to the future price of certain foods,[7] and the possibility that second-round effects on inflation might emerge via wages and/or profit margins.

Chart 18

18.a Inflation in Spain: variation and contribution of components



SOURCES: Eurostat and Banco de España.

a Headline inflation excluding energy and food.

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6 For further details on the future inflation outlook, see the Projections in this report.

7 It is estimated that food products affected by the drought are likely to account for between 15% and 20% of the total food component of the HICP.

19 Overall, wages continue to rise somewhat, slightly more so in the sectors hardest hit by labour supply shortages

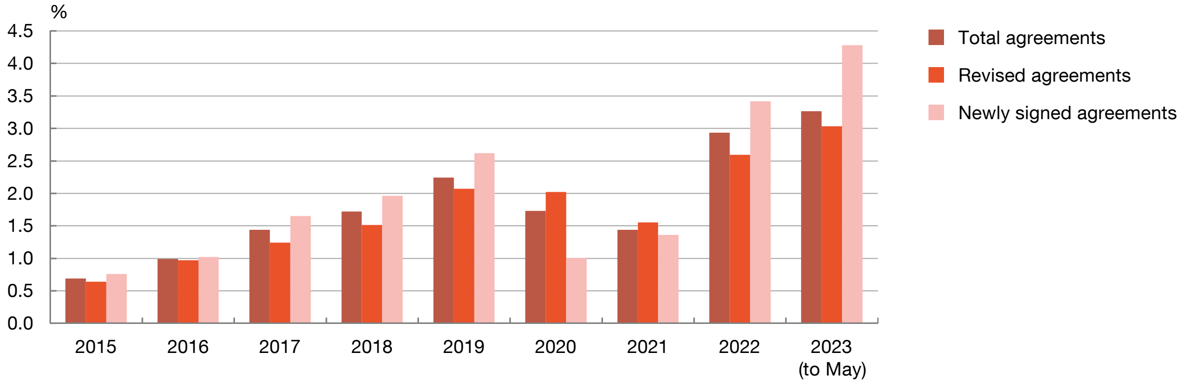
— According to the data on the collective bargaining agreements registered up to May, the average wage rise agreed for 2023 stands at 3.3%, slightly above the 2.9% agreed for last year. Within these agreements overall, those signed in 2023 – affecting around 1.5 million workers – provide for a higher average wage increase of 4.3% (see Chart 19.a).

— By activity, the wage increases agreed for 2023 tend to be higher in sectors in which workers are more scarce (proxied by the job vacancy rate), such as information and communication activities, and professional, scientific and technical activities (see Chart 19.b).

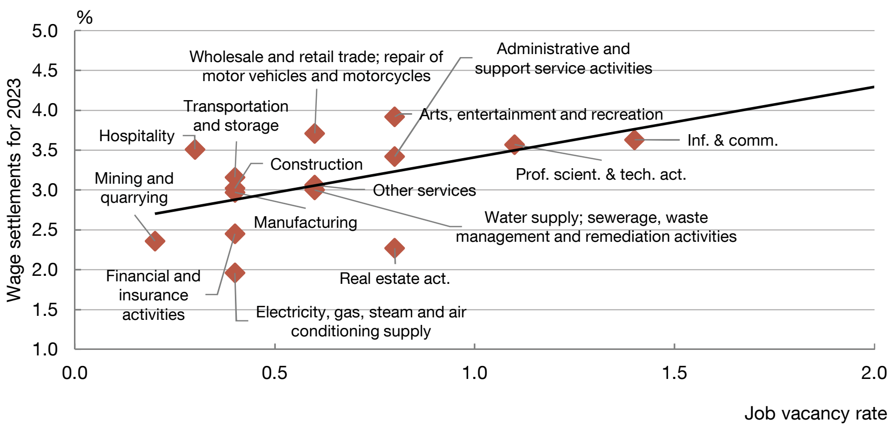
— Looking ahead, the fifth Employment and Collective Bargaining Agreement recently signed by Spain's main social partners includes recommended wage increases of 4% for 2023, and 3% for 2024 and 2025, notably mitigating the risks that second-round effects on inflation might emerge via wages.

Chart 19

19.a Wage settlements



19.b Wage settlements and job vacancy rate by sector



SOURCES: Ministerio de Trabajo y Economía Social and EUROSTAT.

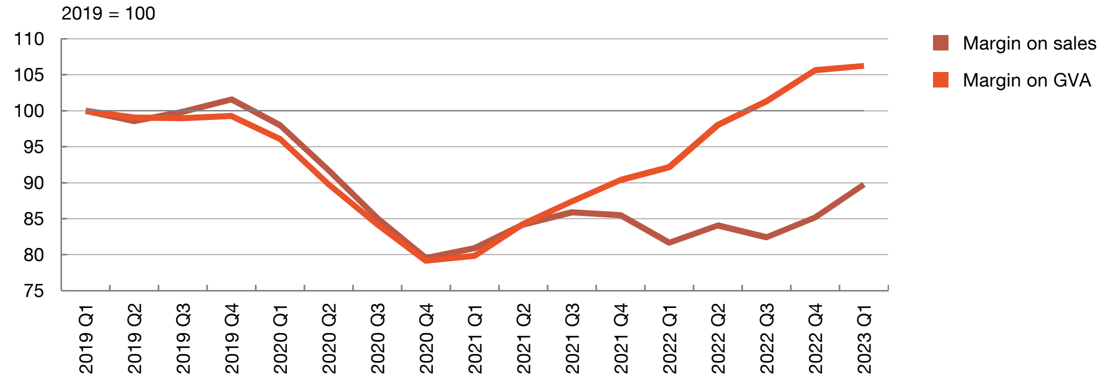
20 Profit margins seem to have continued to recover in the early months of 2023, albeit with high heterogeneity across sectors

— According to the information from the sample of firms in the Banco de España's Central Balance Sheet Data Office Quarterly Survey (CBQ), profit margins – proxied by both the ratio of gross operating profit (GOP) to gross value added (GVA) and the ratio of GOP to turnover – rose in 2023 Q1, although the margin on sales remains below its 2019 level (see Chart 20.a).

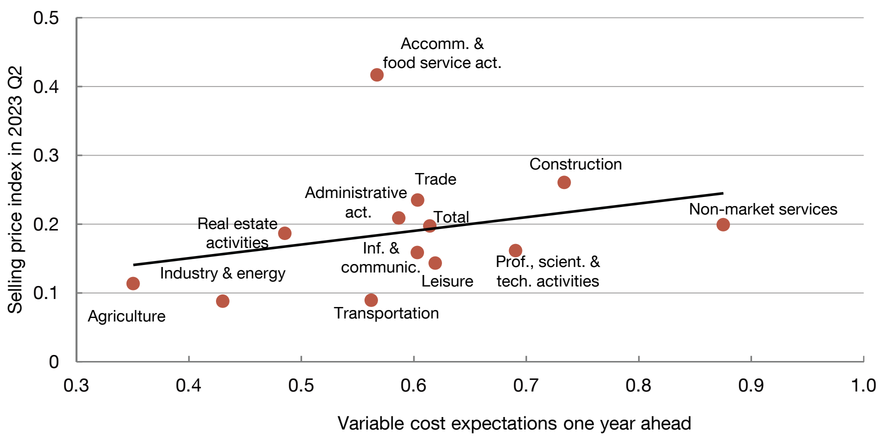
— Nevertheless, the results of the EBAE point to high heterogeneity in selling prices across sectors, which appears to be at least in part attributable to the differences in firms' expectations about future cost increases (see Chart 20.b). As these expectations have begun to edge down in recent months, a slight slowdown might be expected in price and profit margin increases in the future (Glover, Mustre-del-Río and Ende-Becker, 2023).

Chart 20

20.a Changes in profit margins according to CBQ data (a)



20.b Firms' selling prices and cost expectations (b)



SOURCES: INE and Banco de España.

a Margin on sales is defined as the ratio of GOP to net turnover. Margin on GVA is defined as the ratio of GOP to GVA. Both metrics are based on the CBQ. Four-quarter cumulative data.

b Results of the EBAE for 2023 Q2. The price and cost indices are constructed by assigning the following values to the firms' qualitative responses: significant increase = 2; slight increase = 1; unchanged = 0; slight decrease = -1; significant decrease = -2. Variable costs are calculated by weighting intermediate costs and labour costs by their weights calculated using National Accounts data.

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21 The Banco de España's latest macroeconomic projections revise GDP growth for 2023 upwards and average headline inflation for this year downwards

— The last section of this report describes the key features of the Banco de España's latest macroeconomic projections for the Spanish economy over the horizon 2023-2025.

— Under the assumptions of the exercise, Spanish GDP is projected to grow by 2.3%, 2.2%, and 2.1% in 2023, 2024 and 2025, respectively. Compared with the projections published in March, the current projections revise GDP growth for 2023 up by 0.7 pp, essentially due to stronger output growth in the year to date and the revision to the data for 2022 implied by the flash QNA data, published by the INE in April. Also, the commodity price assumptions are now somewhat more conducive to growth in 2023, although this effect is offset by tighter financial conditions having a more negative impact on economic activity than was envisaged in the March exercise. As regards the rest of the projection horizon, the growth projected for 2024 is revised downwards slightly (by 0.1 pp), while for 2025 it remains unchanged.

— Compared with the March projections, the average inflation rate for 2023 is revised downwards by 0.5 pp to 3.2%. This revision is mainly explained by a sharper-than-expected slowdown in energy prices – both in recent months and looking ahead – and, to a lesser extent, in food prices. Over the rest of the projection horizon, in line with the March projections, the rate of headline inflation is expected to rise to 3.6% in 2024 (as a result of the withdrawal of the measures rolled out by the authorities to tackle the energy crisis), before moderating, to 1.8%, in 2025.

— Against a backdrop in which uncertainty is still very high, the risks to the growth projections are mainly tilted to the downside, while for the inflation projections, they are considered to be balanced.

Figure 1

	2023	2024	2025
GDP	2.3% ↑ 0.7 pp	2.2% ↓ 0.1 pp	2.1% 0.0 pp
Inflation	3.2% ↓ 0.5 pp	3.6% 0.0 pp	1.8% 0.0 pp

SOURCE: Banco de España.

MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2023-2025)

Macroeconomic projections for the Spanish economy (2023-2025)

This section describes the key features of the most recent update to the Banco de España's macroeconomic projections for the Spanish economy. Under the assumptions of the exercise, Spanish GDP – which grew by 5.5% in real terms in 2022 – is projected to rise by 2.3%, 2.2% and 2.1% in 2023, 2024 and 2025, respectively (see Table 1).[1] On the price side, headline inflation – which stood at 8.3% on average in 2022 – will fall to 3.2% in 2023 and increase slightly to 3.6% in 2024, before declining to 1.8% in 2025. Meanwhile, underlying inflation will stand at 4.1% this year (0.3 percentage points (pp) higher than in 2022), before slowing to 2.1% and 1.7% over the next two years.

Activity

Activity proved more buoyant in early 2023 than estimated a few months ago. According to the flash estimate published by the National Statistics Institute (INE), GDP grew by 0.5% quarter-on-quarter in 2023 Q1, 0.2 pp more than projected by the Banco de España in March.[2] Growth in Q1 was driven by net external demand – which made a positive contribution of 1.3 pp to output growth – and investment, particularly in capital goods. Conversely, household consumption, affected by the significant erosion of household real income since the start of the current inflationary episode, fell for the second consecutive quarter.

When the INE published the flash estimate for 2023 Q1, it also revised the seasonally adjusted historical data. Specifically, the INE revised down quarter-on-quarter GDP growth in 2022 Q1 by 0.4 pp, while it was revised up by 0.3 pp, 0.1 pp and 0.2 pp in the second, third and fourth quarters, respectively. Overall, these changes have a considerable positive carry-over effect (of 0.3 pp) on GDP growth in the current year.

Economic activity has gathered pace slightly in 2023 Q2. With the caveat that the information available is incomplete, quarter-on-quarter GDP growth in Q2 is estimated at around 0.6%. In this respect, the latest edition of the Banco de España Business Activity Survey (EBAE) evidences that firms' perception of their turnover is better in this quarter than in Q1.[3] In addition, the average

1 The current projections incorporate the new information that has become available since the publication of the previous projections on 22 March. Specifically, the new information includes the Quarterly National Accounts (QNA) flash estimate for 2023 Q1 (which also entailed significant revisions to the data for preceding quarters), the Quarterly Non-Financial Accounts for the Institutional Sectors for 2022 Q4 and the higher-frequency information that has come to light since the cut-off date for the March projections. The projections also factor in the changes observed in the technical assumptions used as a starting point for projecting the different macroeconomic aggregates (see Table 2). The cut-off date for the data included in the projections is 23 May, except for the export market assumptions, for which it is 29 May.

2 "Macroeconomic projections for the Spanish economy (2023-2025)". *Economic Bulletin - Banco de España,* 1/2023. https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/23/T1/Files/be2301-it-Proye.pdf

3 See Fernández Cerezo and Izquierdo (2023).

Table 1
Macroeconomic projections for the Spanish economy (2023-2025) (a)

Annual rate of change (%)

	GDP				HICP				HICP excluding energy and food				Unemployment rate (% of labour force) (b)			
	2022	2023	2024	2025	2022	2023	2024	2025	2022	2023	2024	2025	2022	2023	2024	2025
June 2023	5.5	2.3	2.2	2.1	8.3	3.2	3.6	1.8	3.8	4.1	2.1	1.7	12.9	12.2	11.5	11.3
March 2023	5.5	1.6	2.3	2.1	8.3	3.7	3.6	1.8	3.8	3.9	2.2	1.8	12.9	12.7	12.3	12.0

SOURCES: Banco de España and INE.
NOTE: Latest QNA figure published: 2023 Q1.

a Projections cut-off date: 31 May 2023.
b Annual average.

Table 2
International environment and monetary and financial conditions (a)

Annual rate of change (%), unless otherwise indicated

		June 2023 projections			Difference between the current projections and the March 2023 projections (b)		
	2022	2023	2024	2025	2023	2024	2025
Spain's export markets (c)	8.0	0.8	3.1	2.9	-1.8	0.1	-0.2
Oil price in dollars/barrel (level)	103.7	78.0	72.6	70.4	-3.8	-4.6	-3.2
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1,05	1.08	1.09	1.09	0.02	0,02	0.02
Nominal effective exchange rate against non-euro area countries (d) (2000 = 100)	112.1	115.4	115.6	115.6	1.4	1.7	1.7
Short-term interest rates (3-month EURIBOR; level) (e)	0.3	3.4	3.4	2.9	-0.1	-0.4	-0.3
Long-term interest rates (10-year Spanish government bond yield; level) (e)	2.2	3.5	3.6	3.8	-0.2	-0.2	-0.2

SOURCES: ECB and Banco de España.

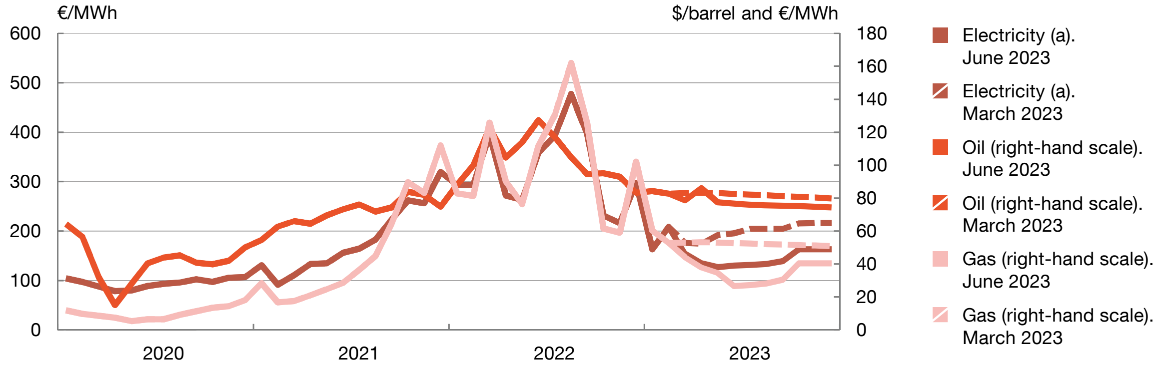
a Cut-off date for assumptions: 29 May for Spain's export markets and 23 May for all other variables. Figures expressed as levels are annual averages; the figures expressed as rates are calculated on the basis of the related annual averages.
b The differences are in rates for export markets, in levels for oil prices, the dollar/euro exchange rate and the nominal effective exchange rate, and in percentage points for interest rates.
c The assumptions regarding the behaviour of Spain's export markets presented in the table are obtained from the June 2023 Eurosystem staff macroeconomic projections for the euro area.
d A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
e For the projection period, the figures in the table are technical assumptions, prepared following the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

for April and May of both the growth in social security registrations and business and household confidence indicators reached higher levels than those recorded in 2023 Q1.

The upswing in activity in 2023 to date is attributable to a combination of different factors. In particular, economic growth has recently been boosted by a further drop in gas and,

Chart 1

1.a Energy prices



SOURCES: Mercado Ibérico del Gas, Operador del Mercado Ibérico-Polo Portugués and Reuters.

a Regulated rate for small consumers of electricity.

consequently, electricity prices (see Chart 1), favourable global economic developments, the easing of production bottlenecks, the stabilisation of financial markets after the turmoil in March and the considerable momentum that the tourism-related and more contact-intensive services have continued to exhibit in recent months – in contrast to the sluggishness of manufacturing. The public sector has also continued to underpin activity.

However, the information for the final stretch of Q2 is consistent with the buoyancy of activity easing slightly. For instance, although the available confidence and social security registration indicators suggest that activity has been stronger in Q2 than in Q1, May's data are slightly less positive than April's. Similar signs of a recent loss of steam have also been detected globally, especially in the Chinese and euro area economies. According to the latest revision to the national accounts statistics published by Eurostat, euro area GDP decreased by 0.1% in 2023 Q1. As a result, the euro area economy shrank – albeit very modestly – for two consecutive quarters and therefore entered technical recession. In addition, the latest short-term economic indicators for this region suggest that the pace of growth of output in Q2 will be slower than projected a few months ago.

Nevertheless, at what remains a complex and highly uncertain juncture, economic activity is expected to continue growing in the coming quarters. Factors that will contribute to this growth include: labour market resilience, which will boost the recovery in household consumption by helping reduce precautionary saving; easing price pressures, which, amid a moderate increase in wage settlements, are helping to halt the deterioration in the purchasing power of wages and shore up household confidence; and the expected faster roll-out of the Recovery and Resilience Facility projects, which will further strengthen business investment. In addition, goods exports will be aided in the coming quarters by the dissipation of persisting global supply chain disruptions and by the competitiveness gains over the rest of the euro area, as a result of the relatively contained labour costs in Spain, and over third countries, due to lower energy costs.

Table 3
Projections for the main macroeconomic aggregates of the Spanish economy (a)

Annual rate of change in volume terms (%) and % of GDP

		June 2023 projections			March 2023 projections		
	2022	2023	2024	2025	2023	2024	2025
GDP	5.5	2.3	2.2	2.1	1.6	2.3	2.1
Private consumption	4.4	0.2	3.3	2.0	1.2	2.3	2.2
Government consumption	-0.7	0.6	0.8	1.3	0.5	0.8	1.2
Gross fixed capital formation	4.6	1.7	4.1	2.8	0.3	3.9	3.0
Exports of goods and services	14.4	7.1	2.2	3.0	3.1	2.9	3.0
Imports of goods and services	7.9	3.2	4.0	3.1	1.8	3.1	3.1
Domestic demand (contribution to growth)	3.1	0.6	2.8	2.0	1.0	2.3	2.1
Net external demand (contribution to growth)	2.4	1.7	-0.6	0.1	0.6	0.0	0.0
Nominal GDP	10.0	6.8	5.4	4.1	5.3	5.4	4.1
GDP deflator	4.3	4.4	3.2	2.0	3.6	3.0	1.9
HICP	8.3	3.2	3.6	1.8	3.7	3.6	1.8
HICP excluding energy and food	3.8	4.1	2.1	1.7	3.9	2.2	1.8
Employment (hours)	4.1	1.7	1.8	1.1	0.9	1.3	1.0
Unemployment rate (% of labour force). Annual average	12.9	12.2	11.5	11.3	12.7	12.3	12.0
Net lending (+) / net borrowing (-) of the nation (% of GDP)	1.5	4.8	3.9	3.5	2.3	2.1	1.5
General government net lending (+) / net borrowing (-) (% of GDP)	-4.8	-3.8	-3.4	-4.0	-4.1	-3.5	-4.4
General government debt (% of GDP)	113.2	109.7	107.4	108.0	111.1	108.8	109.9

SOURCES: Banco de España and INE.
NOTE: Latest QNA figure published: 2023 Q1.

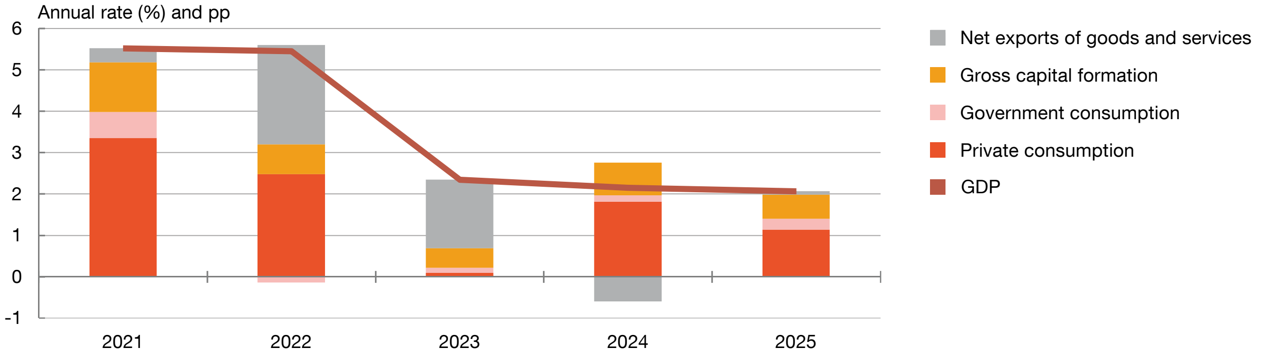
a Projections cut-off date: 31 May 2023.

Even so, economic activity will come up against some major hurdles in the coming quarters. These notably include tighter financing conditions and the further tightening agents expect in the short term, which will continue to hold back growth in household and business spending. In addition, while the short-term outlook for inbound tourism is positive, the contribution of tourism exports to GDP will become increasingly smaller in the future, once this variable recovers its pre-pandemic levels. Lastly, the gradual withdrawal of the measures applied in response to the energy crisis, which have helped cushion its impact on private agents and have therefore underpinned activity since inflation began to rise, will also weigh on output growth in the Spanish economy over the projection horizon.

In annual average terms, GDP has a relatively flat profile over the projection horizon. In 2023 GDP will grow by 2.3%, underpinned by the sound performance of the external sector and gross capital formation (see Table 3). By contrast, the contribution of private consumption to annual growth will be limited, as it is held back by the decrease in this demand component in

Chart 2

2.a GDP growth and contributions of main components



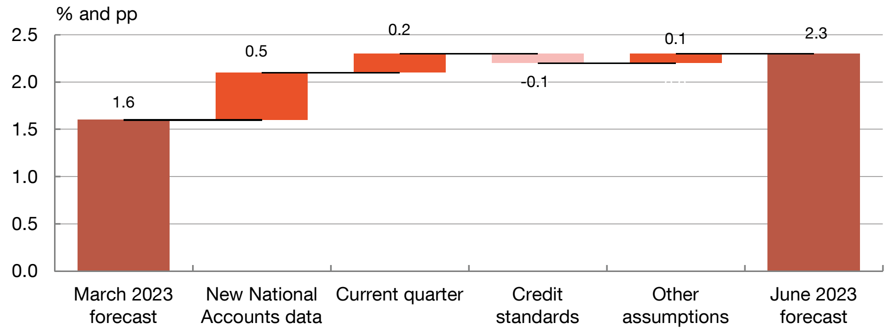
SOURCE: INE.

recent quarters and its sluggishness in Q2. Growth in activity will ease slightly, by 0.1 pp in each of the two following years, to 2.1% in 2025. In any event, the composition of GDP growth in 2024 and 2025 will differ greatly from that projected for 2023, as it will shift to rest mainly on growth in private consumption (see Chart 2). After a weak start to the year, this demand component will recover significantly in 2023 H2 and continue to grow, albeit somewhat less buoyantly, over the rest of the projection horizon. These developments will continue to be underpinned by easing price pressures and the resilience of the labour market. Specifically, in line with the projected growth in output, the recent strong job creation is expected to continue throughout the projection horizon. As a result, the unemployment rate will fall to around 11% on average in 2025, despite the labour force being expected to increase.

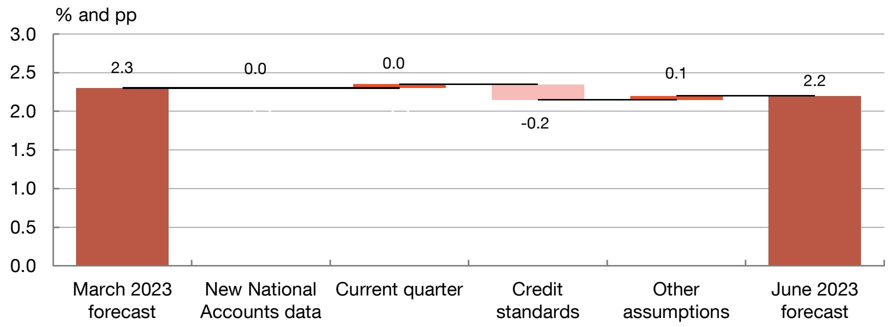
Compared with those published three months ago, the current projections revise up GDP growth for 2023 by 0.7 pp (see Chart 3.a). The main factor behind this revision is the carry-over effect on the annual average rate for 2023 of the significant upward revision to the GDP growth rates between the second and fourth quarters of 2022 published by the INE at the end of April. In addition, according to the QNA flash estimate for 2023 Q1, the pace of growth of output in that period surprised on the upside compared with the Banco de España's March projections. In the absence of other changes, the incorporation of these two factors would together revise up the average GDP growth rate for 2023 by 0.5 pp. In the current projections, activity is estimated to be more buoyant in Q2 than expected in March, which also revises up GDP growth in 2023 as a whole. Lastly, the new assumptions underpinning the projection exercise do not entail significant revisions to the growth rate for this year (see Table 2). Specifically, although the assumptions about commodity prices are now more conducive to the growth of activity in 2023 and a somewhat stronger euro helps lower the prices of these goods compared with the March projections, this is offset by the more adverse impact than projected in March of financing conditions and, in particular, the tightening of credit standards. For 2024, the changes in the assumptions translate into a slight downward revision (0.1 pp) to GDP growth compared with March, mainly as a result of a sharper tightening of credit standards than expected in those projections (see Chart 3.b).

Chart 3

3.a Changes in the GDP growth forecast for 2023



3.b Changes in the GDP growth forecast for 2024



SOURCES: INE and Banco de España.

Prices and costs

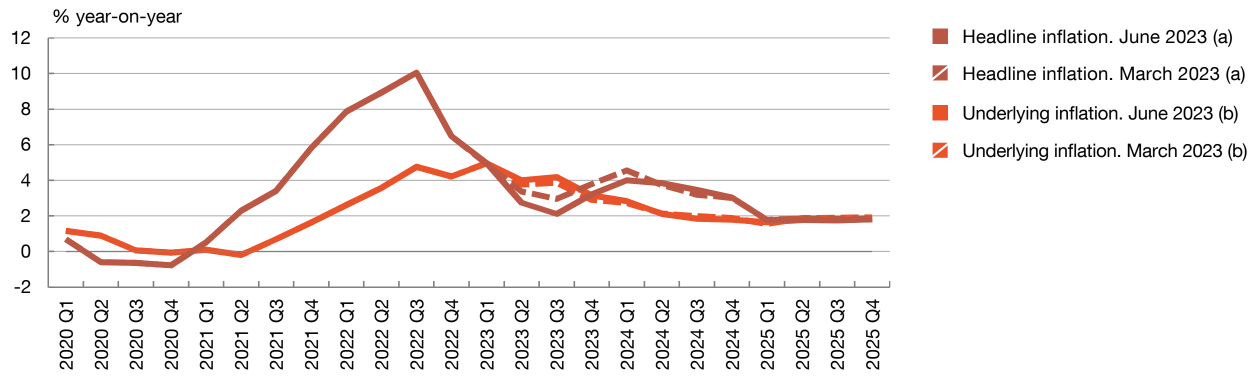
Headline inflation has continued to fall in Q2. The harmonised index of consumer prices (HICP) ran at 2.9% in May, down 2.5 pp from end-2022 and 0.1 pp on the rate recorded in March (see Chart 4.a). By component, energy consumer goods prices have continued to decline sharply in recent months. Specifically, this component fell by 19.5% year-on-year in May, in a highly volatile setting in which these rates of change are particularly affected by the base effects stemming from the sharp changes their prices saw around the time of the outbreak of the war in Ukraine.

The annual growth rate of food prices and underlying inflation have started to show incipient signs of slowing. Food inflation, which stood at 11.6% in May, is highly likely to have peaked in Q1 (specifically, at 15.7% in February). Underlying inflation, which in February recorded its highest figure since the time series began in 1997 (5.2%), fell in May for the third consecutive month, to 3.8%.

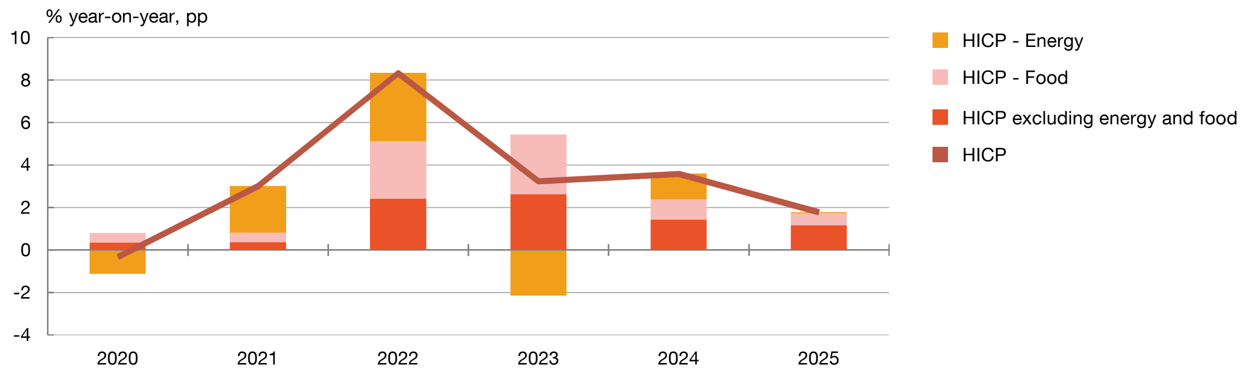
The path of headline inflation will be determined in the short term by energy price developments. The lower energy commodity prices signalled by the futures markets will translate,

Chart 4

4.a Headline and underlying inflation



4.b Contributions to HICP growth by component



SOURCES: INE and Banco de España.

a Measured by the HICP.
b Measured by the HICP excluding energy and food.

up to the end of the summer, into further declines in fuel, gas and electricity prices. However, in the final stretch of 2023, the annual growth rate of energy prices will rise due to the base effects linked to the declines in those prices at the end of 2022. In addition, assuming that the main measures deployed by the authorities to mitigate the effects of the energy crisis will expire at end-2023, this increase in energy price inflation and, as a result, headline inflation will extend into early 2024.

Non-energy HICP will slow in the second half of the year, although this will not prevent its annual average rate from being higher than in 2022. The projected slowdown in food prices is explained by the lower cost of some production inputs, after they surged during much of last year. However, poorer harvests of certain crops due to adverse weather conditions will tend to somewhat limit this price moderation. The deceleration in underlying inflation in the final stretch of the year will foreseeably be due to the fading of the remaining distortions in global supply chains, the gradual impact of monetary policy tightening on demand, the easing of the inflationary pressures stemming from the reopening of the economy after the pandemic and the gradual, albeit somewhat delayed, pass-through of recent decreases in energy costs to the prices of other goods and services (see Chart 4.a). Among the components of underlying inflation, the slowdown is expected to be more pronounced in non-energy industrial goods than in services in the coming quarters, as in the first months of 2023, given their respective cost structures. Specifically, in the first case, intermediate inputs – whose prices have recently slowed down or, in some cases, declined – account for a greater relative share of costs, while, in the second, the share of wage costs – which are picking up slightly – is higher. In addition, the expected high summer demand for recreation and tourism services will exert some upward pressure on their prices.

Consumer prices will decelerate sharply over the projection horizon as a whole. In particular, in 2023 the inflation rate, measured by the year-on-year increase in the HICP, will decline in annual average terms to 3.2%, down from 8.3% in 2022 (see Chart 4.b). In 2024 it will rise temporarily to 3.6%, as a result of most of the measures launched by the authorities in response to the inflationary crisis expiring. This will result in high growth in the energy component, which will more than offset the expected reduction in food and underlying inflation. Under the assumptions of this projection exercise, the stabilisation of the energy component and the continued disinflation in the non-energy HICP will result in headline inflation of 1.8% in 2025.

These inflation projections are based on two assumptions. First, the outlook described is based on the assumption that, while the pass-through of past increases in production costs to selling prices is not yet complete, the pass-through of the most recent decline in such costs will prevail in the coming months. In any event, some asymmetry in the pass-through of changes in energy prices to other consumer prices has been incorporated into the projections, whereby consumer prices respond more strongly when energy input prices rise than when they fall, which makes underlying inflation slightly downwardly sticky. Second, in line with developments to date, it is assumed that no significant second-round effects that might trigger a wage-price spiral will emerge over the projection horizon. The validity of this assumption, which was already included in previous projection exercises, has been strengthened by the social partners signing the fifth Employment and Collective Bargaining Agreement. Although this has barely altered the projected compensation per employee over the projection horizon, it has reduced the degree of uncertainty surrounding this forecast.

Compared with the March projections, in the current projections headline inflation is revised down for 2023 and there are no significant differences in the two subsequent years (see Chart 4.a). By component, the downward revision to the inflation projections for 2023 is due mainly to the lower contribution from energy, given the behaviour of oil and gas prices on the spot and futures markets (see Chart 1.a) and the slight appreciation of the exchange rate compared with that anticipated in March. It also owes to a slight downward revision to the contribution of food prices, which have surprised on the downside in recent months. Conversely, compared with the March projections, higher increases in underlying inflation are now expected for this year, given the recent upward surprises in this item.

Risks

Against a backdrop that remains highly uncertain, the risks to the growth projections are mainly tilted to the downside, while for the inflation projections they are considered to be balanced. In recent quarters, the surge in global inflation has required synchronised and sharp monetary policy tightening by the world's main central banks, which is not expected to be reversed appreciably in the short term and may even continue for some time in certain jurisdictions. In this respect, some of the incipient signs of weakening activity recently observed in Spain and other economies already appear to be reflecting the adverse effects of tighter financing conditions on macroeconomic aggregates. Should these signs of weakness worsen in the coming months (beyond what is already envisaged in these projections' baseline scenario), domestic and external demand would fall and, therefore, so would economic growth and inflation.

Quantifying the impact of tighter financing conditions and reduced access to credit on activity is very complex. In light of the most recent short-term indicators, the current projections consider that these adverse effects will be somewhat larger than in the previous projections. However, the negative impact of these financial channels on activity and prices could be amplified if episodes of turmoil in international capital markets – such as those observed in March – were to trigger an increase in risk aversion.

Moreover, it is difficult to measure the extent and speed of the pass-through of the recent declines in some commodity prices to the overall consumption basket. There is considerable uncertainty about how the possible incomplete pass-through of the cost increases seen up to mid-2022 and the subsequent drops in the prices of many commodities interact with each other. In the baseline scenario it is assumed, as mentioned above, that the pass-through of the most recent price declines will be incomplete and relatively slow, in line with some of the empirical evidence available. However, the information on households' and firms' expectations about future price developments from the European Commission survey and the EBAE suggests that non-energy HICP disinflation could be stronger than assumed in the baseline scenario.

Nevertheless, the incipient signs of deceleration in underlying inflation in Spain and other countries will still need to be confirmed in the coming months. The moderation of non-energy inflation is very modest in Spain for the time being, and even more so in other jurisdictions. In this setting, it cannot yet be ruled out that the persistence of high underlying inflation rates will trigger significant second-round effects on prices via wages and/or profit margins, which could exacerbate the current inflationary dynamics and, should this scenario occur in the euro area overall, require more forceful monetary policy action. This would lead to a further tightening of financing conditions and, therefore, a further weakening of private agents' spending.

There are also other very important sources of uncertainty. At international level, of note, as in previous quarters, is the future course of the current geopolitical tensions and the war in Ukraine. A possible heightening of these tensions would very likely lead to a further rise in commodity prices and, therefore, a pick-up in inflation and a downturn in activity. On the domestic front, doubts remain over how much the savings built up during the pandemic can support private consumption and over the pace of implementation of the projects under the Next Generation EU programme and their impact on activity.

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Annex 1
Assumptions underlying the projections

Compared with the March projections, the technical assumptions used as a starting point for the current projection exercise entail a downward revision to energy prices, for oil and, above all, gas (see Table 2). Money market and sovereign debt interest rates expected by financial markets in the coming years are currently somewhat lower. In line with these revisions, new lending is now expected to cost slightly less over the projection horizon than forecast three months ago. However, in terms of future lending volumes, this will be more than offset by the further tightening of credit terms and conditions and credit standards. Lastly, the exchange rate is somewhat higher than in the March projections and the pace of growth of export markets has been revised down in 2023, mainly due to the carry-over effect from the weaker performance of world trade in the final stretch of 2022 compared with three months ago.

The fiscal assumptions incorporate the measures approved by the authorities since the cut-off date for the March projections. These include, first, Royal Decree-Law 2/2023 on the reform of the pension system, which provides, among other measures, for a gradual increase in social security contributions and a rise in minimum pensions between 2024 and 2027. Over the projection horizon, this legislative reform will have an estimated positive impact on net revenue of around 0.1 percentage points (pp) of GDP in 2025. Second, the new subsidies to the primary sector and the transport subsidies for young people have been incorporated. Together, they entail a slight temporary deterioration in the 2023 general government balance of 0.1 pp of GDP.[4] Meanwhile, in light of the latest data published (for 2022), the potential materialisation of the losses associated with loans guaranteed by the Spanish Official Credit Institute (ICO) has been deferred, meaning that the impact is now lower in 2023 and higher in 2024 and 2025. Finally, based on the latest information available, the expected path of expenditure financed with European funds from the Recovery and Resilience Facility is unchanged over the entire projection horizon, although it remains subject to considerable uncertainty.

The projections for other budget items are based on the measures previously approved (and, therefore, incorporated into the previous projection exercises) and on the usual technical assumptions, together with the assumption that the upward surprises in tax revenue that were seen mainly in 2020-2021 will partially reverse. The gradual withdrawal of the measures implemented in response to the pandemic and the energy crisis will have a positive effect on the general government balance of around 1 pp of GDP, in both 2023 and 2024. By contrast, in 2025 the impact will be negative (and amount to -0.4 pp of GDP) owing to the discontinuation of the temporary tax measures introduced to finance part of the costs associated with the energy crisis-related subsidies.[5]

4 Ministerial Order HFP/405/2023 and Royal Decree-Law 4/2023. This Royal-Decree Law is pending validation by Parliament. However, as it has been dissolved, this procedure will have to be carried out by the Permanent Deputation.

5 Temporary levies on the financial and energy sectors, a wealth tax and a limit for consolidated groups on offsetting losses for corporate income tax purposes.

Overall, the expected fiscal policy stance in 2023, measured as the change in the primary structural balance, would be slightly expansionary after the impact of the European funds is taken into account.[6] In 2024, the fiscal stance would turn moderately contractionary due to the withdrawal of the support measures, before becoming expansionary again in 2025.

6 The Recovery, Transformation and Resilience Plan funds do not affect the Spanish budget deficit, as they allow for a higher level of spending without the corresponding funds needing to be sourced from resident agents. Therefore, they entail an expansionary impulse that does not result in a change in the balance.