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

Contents

EDITORIAL

Editorial

Global economic activity has slowed in recent months. In Q2, the deceleration was particularly pronounced in China, against a background of notable weakness in the real estate sector. Other economies were, by contrast, more buoyant. In particular, the United States stood out, with strong domestic demand underpinned by its robust labour market. As regards Q3, the available evidence suggests a further slowdown in world activity, with divergence, once again, across geographical areas. At sector level, manufacturing continues to show considerable slack, especially in comparison with services. That said, the buoyancy of the latter sector has tended to moderate over the summer months.

The euro area economy remains somewhat subdued. Euro area GDP stagnated in the final quarter of 2022 and grew by only 0.1% in each of the first three quarters of 2023. The PMI indicators available to August suggest that activity has become even weaker during the summer. As at global level, developments in manufacturing, against a background of weakening demand outside the euro area and tightening financial conditions, have been particularly unfavourable. Moreover, the outlook is not encouraging either, in view of the poor behaviour of orders. Services have also shown signs of slackening over the summer, probably reflecting the spillover of the sluggishness in the industrial sectors and also, possibly, the fading of the stimulus provided by pent-up demand following the pandemic.

In spite of the weakness of GDP growth, job creation in the euro area has been relatively strong. Indeed, compared with 0.2% GDP growth in cumulative terms between 2022 Q4 and 2023 Q2, employment increased by almost 1%. Possible reasons for this apparent discrepancy (also observed in other economies) include the fact that the composition of recent economic growth has been skewed towards services, which are more labour-intensive than industry, and a certain amount of labour hoarding by firms. The latter reflects labour market tightness, evident in the low unemployment rates and high level of unfilled vacancies, which leads to firms retaining workers in the face of modest downturns in activity that are assumed to be temporary.

During the summer, headline inflation in the euro area has remained relatively stable, although this aggregate stability masks diverging trends in its main components. In recent months, the slowdown in food and non-energy industrial goods prices that started at the beginning of the year has continued. In August, services inflation edged down slightly following the rises in previous months. Even so, the growth rate of this component of consumer prices remains very high. These developments have taken place in the context of notably buoyant demand for recreation and hospitality services and hardly any signs of moderation in wage costs, which account for a large part of overheads in these sectors. Lastly, driven by the rise in oil prices resulting from supply cuts implemented by some of the main producing countries, energy inflation surprised on the upside in August.

Economic activity in Spain has also shown signs of weakness over the summer. Having grown by 0.4% in Q2, the latest information available suggests that GDP has grown by around 0.3% in the current quarter. In particular, this conclusion is supported by the PMI indicators, given the steepening of the downtrend that started in the spring, and by the results of the latest Banco de España Business Activity Survey, which indicate a weakening of firms' turnover in Q3.[1] Social security registrations remained on a steady path in Q3. That said, average month-on-month employment growth between May and August was clearly lower than during the first four months of the year.

In any case, GDP growth in Spain has been stronger than in other euro area countries. This is explained, above all, by the differences in the sectoral composition of the Spanish economy. Indeed, the recent strength of activity in Spain appears to be partly related to the greater importance of its hospitality and tourism-related services sectors, which have continued to experience very high demand over the summer. Manufacturing (currently also less buoyant in Spain than services), meanwhile, is comparatively less important in the Spanish economy. Furthermore, the most energy-intensive manufacturing sectors, which have shown the most weakness in recent quarters, have behaved relatively more favourably in Spain than in the euro area as a whole or, for example, in Germany. In addition, the proportion of Spain's exports that goes to China, an economy that has been slowing rapidly, is smaller than in the case of the euro area as a whole.

Headline inflation has picked up somewhat in Spain during the summer months. As food and non-energy industrial goods prices continued to fall, the rise in headline inflation in July and August, compared with the spring months, has mainly reflected the recent increase in heating and vehicle fuel prices and various base effects associated with energy price dynamics in 2022 Q3. In any event, the downward trend in underlying inflation is still moderate.

The latest information suggests activity will remain relatively weak in Q4. This appears to be the result, among other factors, of the persistence of the sluggish external environment and the continuation of the pass-through of monetary policy tightening to the cost of new loans and indebted agents' debt burden.

From the beginning of 2024 activity is expected to regain momentum. This would stem from the recovery in the external environment, the improvement in households' real incomes (as inflation declines over the course of the year) and the expected faster roll-out of the investment projects under the European NextGenerationEU (NGEU) programme. However, the economy's increased dynamism would be weighed down to a certain extent by the completion of the pass-through of monetary tightening to financing conditions, the gradual withdrawal of the support measures rolled out by the authorities in the context of the energy crisis and more muted growth in tourism activity once pre-pandemic levels are regained. Overall, after growing by 2.3% this year, the latest macroeconomic projections of the Banco de España, presented in this Quarterly Report, foresee GDP growth of 1.8% in 2024 and 2% in 2025.

1 Fernández Cerezo, Alejandro and Mario Izquierdo. (2023). "Encuesta a las empresas españolas sobre la evolución de su actividad: tercer trimestre de 2023". *Economic Bulletin - Banco de España,* 2023/Q3. https://doi.org/10.53479/33733

In the short term, the path of the headline HICP in Spain will be shaped mainly by the energy component. The recent rise in oil prices, the upward base effect of the fall in heating and vehicle fuel prices in the final stretch of 2022 and the expiry in 2024 of the government measures implemented to mitigate the consequences of the energy crisis will lead to a pick-up in headline inflation until the middle of next year. However, non-energy inflation is expected to gradually decelerate. The projected disinflation would mainly stem from the completion of the pass-through to consumer prices of past increases in intermediate input costs and monetary policy measures, assuming, in line with developments to date, that current inflationary pressures will not have significant second-round effects that could trigger feedback loops. In annual average terms, HICP inflation is expected to increase from 3.6% in 2023 to 4.3% in 2024, and to decline to 1.8% in 2025.

The risks to the baseline scenario presented in this Quarterly Report are tilted to the downside with regard to activity and balanced with regard to inflation. A very important source of uncertainty is the difficulty in calibrating the scale of the effect on activity and prices of the monetary policy tightening to date, which could lead to scenarios of further weakness in activity and prices or, conversely, to the current high inflationary pressures becoming entrenched. Moreover, global economic developments could unfold more unfavourably than envisaged in the baseline scenario, possibly due to a sharper than expected deceleration of the Chinese economy. In addition, there are multiple areas of instability in the global geopolitical environment that could lead to a scenario of higher inflation and a worse outlook for economic activity if they were to flare up.

REPORT

1 Global economic activity has slowed somewhat in recent months

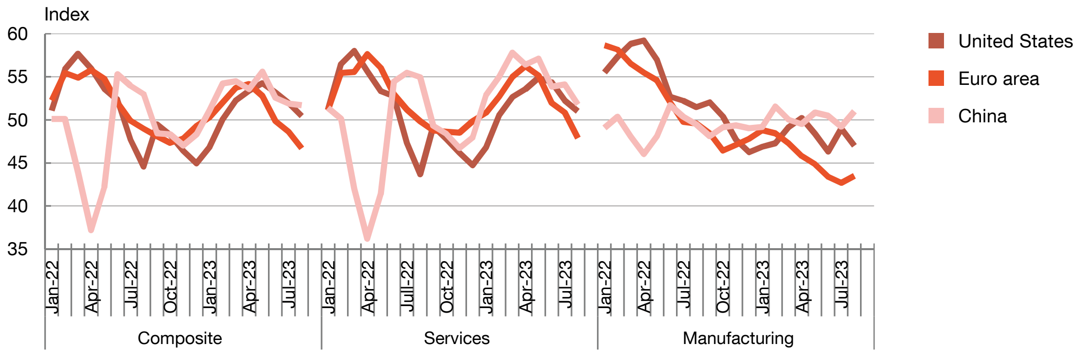
— In 2023 Q2, global growth moderated with respect to that observed in the previous quarter. However, this aggregate performance was marked by highly uneven economic growth across geographical areas. Thus, while GDP growth was higher than expected in some of the main world economies, such as the United States, the United Kingdom and Japan, it surprised on the downside in the euro area and in China.

— According to the available indicators, global economic activity has decelerated further in Q3, as the weakness of the manufacturing sector appears to have spread to services (see Chart 1.a), against a backdrop of tightening financing conditions.

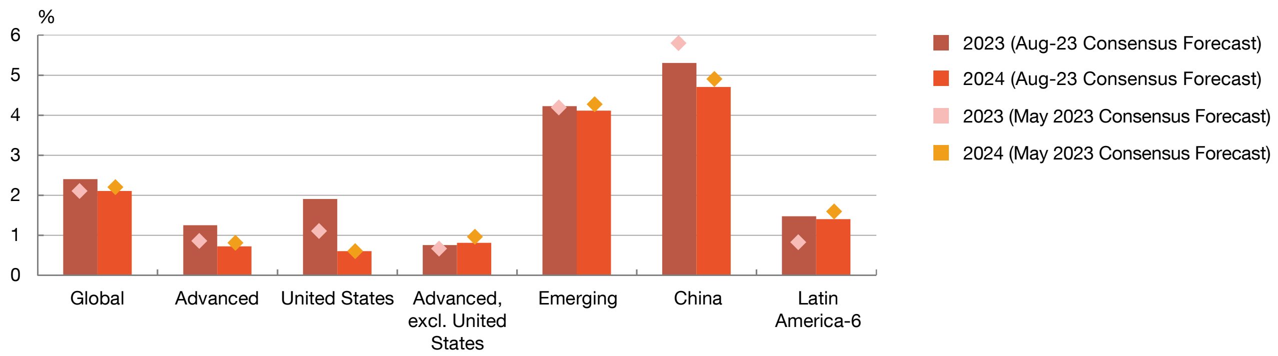
— Overall, these developments have prompted slight revisions to global growth forecasts for 2023 and 2024 (see Chart 1.b). However, the 2023 growth forecast for the United States has been revised significantly upwards (partly on account of its strong labour market), and the forecast for China (owing, among other factors, to the sluggishness of investment and its real estate sector) and the euro area has been revised downwards for this and the coming year.

Chart 1

1.a Purchasing Managers' Indices



1.b Growth forecasts (a)



SOURCES: S&P Global, Consensus Forecasts and Refinitiv.

a "Advanced economies" include United States, the euro area, Japan, United Kingdom, Norway, Sweden, Switzerland and Canada. "Emerging market economies" include Argentina, Brazil, Chile, Colombia, Mexico, Peru, Czech Republic, Hungary, Poland, Romania, Russia, Türkiye, China, India, Indonesia, Malaysia, Philippines and Thailand, and "Latin America-6", Argentina, Brazil, Chile, Colombia, Mexico and Peru.

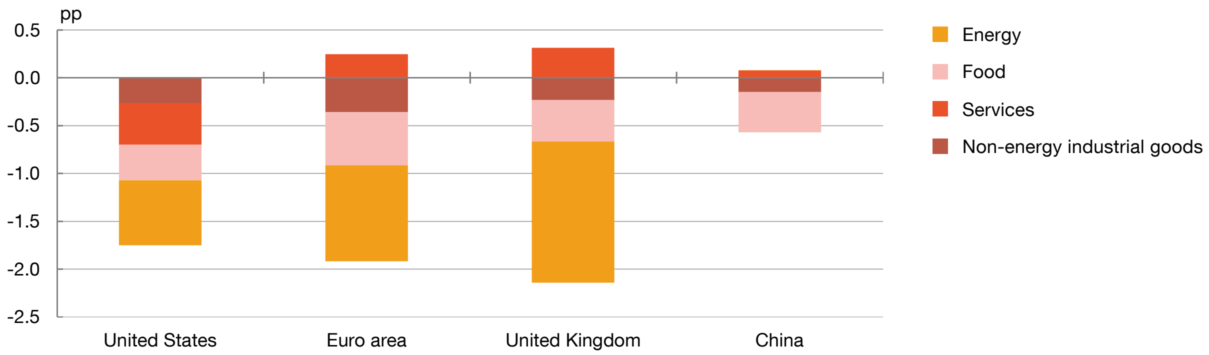
2 Global headline inflation has continued to ease, despite a stronger-than-expected rise in oil prices and still-high underlying inflation

— In recent months, headline inflation rates have continued to decline globally, mainly owing to the lower contribution from food and energy (see Chart 2.a). Nevertheless, recent developments in oil and natural gas prices have surprised on the upside following the materialisation of different adverse supply shocks (see Chart 2.b).

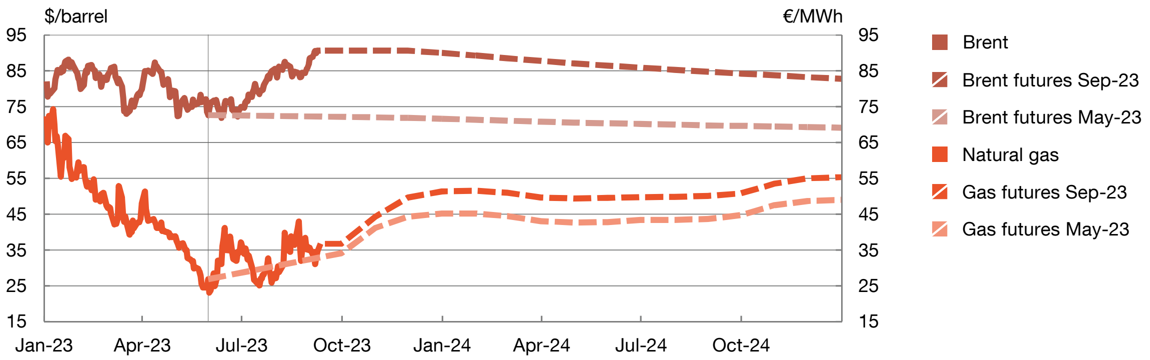
— Moreover, the moderation in underlying inflation is not as marked or widespread as that of headline inflation. Among the components of underlying inflation, services inflation remains persistent and has actually increased in some countries since April (see Chart 2.a). These adverse developments can be attributed to a combination of factors, such as the strength of demand for services in H1, the rise in wages (which account for a relatively high share of the cost structure of services), and the performance of profit margins in that sector.

Chart 2

2.a Breakdown of inflation. Contributions to year-on-year rate. Difference between April and July 2023



2.b Gas and oil prices and futures



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SOURCES: Refinitiv, IMF and national statistics.

3 The pace of global monetary policy tightening has continued to slow in recent months and some central banks have already reduced their interest rates

— Most central banks in emerging market economies have paused their monetary tightening cycles and, in some countries, such as Brazil, Chile, Poland and China, they have even started to cut policy rates, given the moderation in inflation and the slowdown in activity in these economies (see Chart 3.a).

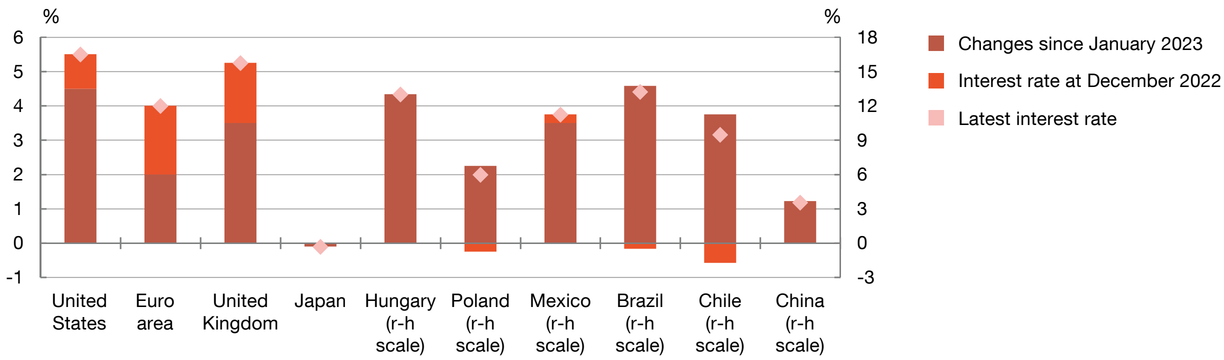
— Among the advanced economies, at their last monetary policy meetings, the US Federal Reserve (on 26 July), the Bank of England (on 2 August) and, more recently, the European Central Bank (ECB) (on 14 September), decided to raise their policy rates by 25 basis points (bp), albeit signalling that they may be entering the final stages of their interest rate hiking cycles.

— In any event, given the persistence of considerable underlying inflationary pressures and the messages conveyed by the world's main central banks, international financial markets have started, in recent months, to assume that interest rates will remain relatively high for longer than expected a few months ago.

— Against this backdrop, recent developments in international financial markets have been marked by an increase in long-term interest rates (for instance, the US and German 10-year benchmark yields have risen by 48 bp (to 4.3%) and 20 bp (to 2.6%) since end-June, respectively[1]), and by the uneven performance of the main global stock market indices, with slight gains in the United States and falls in most European stock markets.

Chart 3

3.a Policy interest rates



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SOURCES: National central banks and Refinitiv.

1 The rise in US sovereign bond yields also partly reflects the announced increase in Treasury issuance and the credit rating downgrade by Fitch in August.

4 In the euro area, economic activity proved weaker than expected

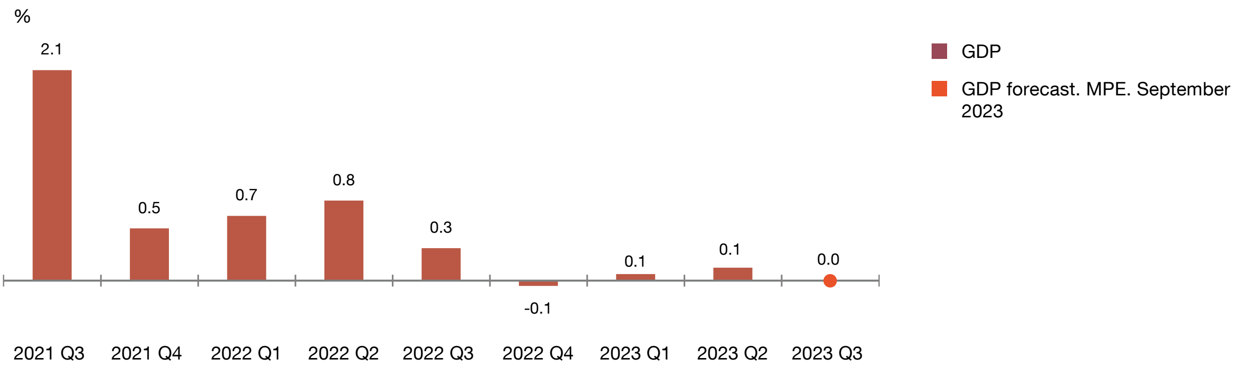
— In line with the sluggishness observed in the early months of the year, euro area GDP grew by only 0.1% in Q2, a lower-than-expected growth rate.

— The latest short-term economic indicators suggest that these signs of relative weakness worsened in the summer months, especially in sectors and demand components (for example, manufacturing and investment) that are more sensitive to tighter financing conditions.

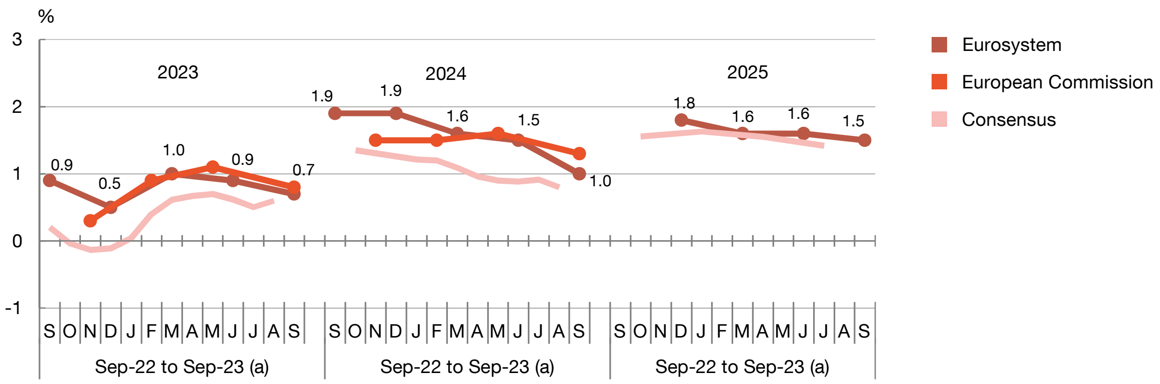
— In this setting, the September ECB staff macroeconomic projection exercise points to euro area GDP growth of around 0% in Q3 (see Chart 4.a). In annual average terms, GDP growth has been revised down over the entire projection horizon in the ECB's baseline scenario. In particular, average growth rates are expected to reach 0.7% in 2023, 1% in 2024 and 1.5% in 2025 (0.2 pp, 0.5 pp and 0.1 pp, respectively, below the June forecasts (see Chart 4.b)).

Chart 4

4.a Euro area. GDP (quarter-on-quarter rate)



4.b Euro area. GDP growth forecasts



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

a The letters refer to the months when the respective forecasts were published.

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5 Headline inflation in the euro area held stable in July and August, in part due to the increase in the energy component and persistently high rates of underlying inflation

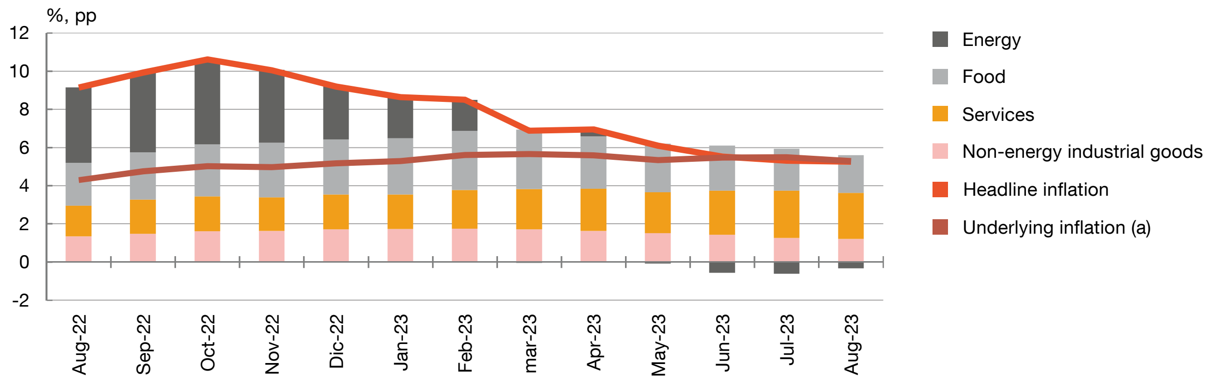
— According to the HICP flash estimate, euro area inflation stood at 5.3% year-on-year in August, higher than expected mainly due to an increase in the energy component. The contribution of food to inflation has continued to decline in recent months, but still remains at high levels (see Chart 5.a).

— Underlying inflation stood at 5.3% in August. This represented a reduction of 0.2 pp on the June figure, attributable to the easing contribution of non-energy industrial goods. Conversely, the contribution of services to the current inflationary pressures held at very high levels.

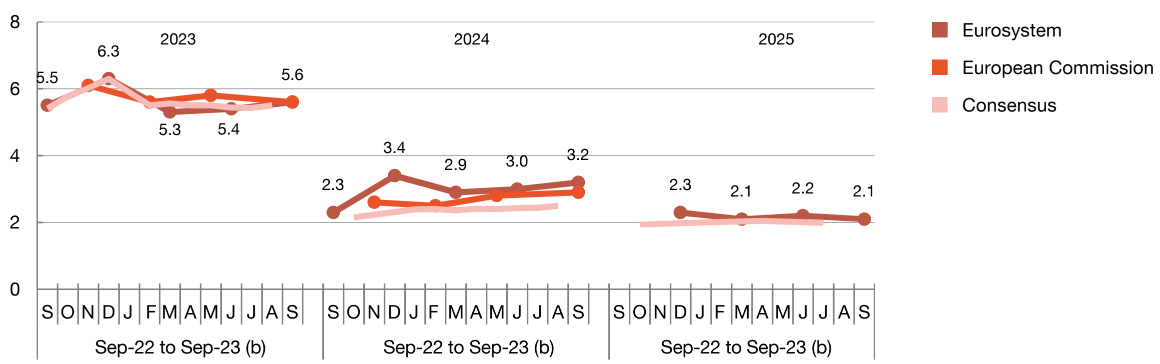
— In the light of these dynamics, and following changes to the assumptions about future developments in energy prices (revised up slightly) and exchange rates (envisaging a slightly more appreciated euro), the September ECB staff macroeconomic projection exercise revises up the headline inflation rates for 2023 and 2024 by 0.2 pp (to 5.6% and 3.2%, respectively) and revises down that for 2025 by 0.1 pp (to 2.1%) (see Chart 5.b).

Chart 5

5.a Euro area inflation and contribution of the components



5.b Euro area. Inflation forecasts



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

a HICP excluding energy and food.
b The letters refer to the months when the respective forecasts were published.

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6 In September, the ECB raised its key interest rates for the tenth consecutive time to reinforce the progress of inflation towards the target rate of 2% over the medium term

— Inflation continues to decline, but is still expected to remain too high for too long.

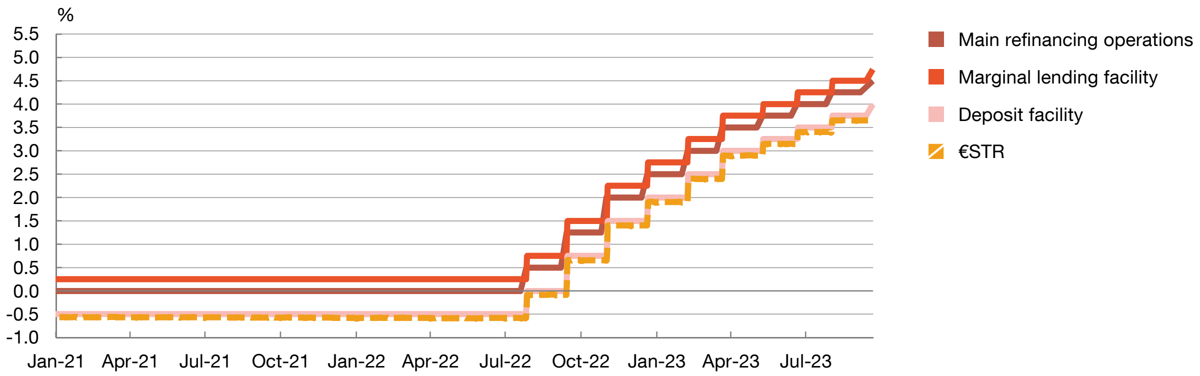
— In consequence, at its September meeting the ECB Governing Council decided to again raise its interest rates by 25 bp, taking the deposit facility rate to 4%, representing a cumulative increase of 450 bp since July 2022 (see Chart 6.a).

— With this decision, and based on its current assessment, the Governing Council considers that the key ECB interest rates have reached levels that, maintained for a sufficiently long duration, will make a substantial contribution to the timely return of inflation to the target.

— The Governing Council's future decisions will ensure that the key ECB interest rates will be set at sufficiently restrictive levels for as long as necessary. It will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction. In particular, its interest rate decisions will continue to be based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission.

Chart 6

6.a Key ECB interest rates and €STR



SOURCES: Banco de España and Refinitiv Datastream. Latest data: 14 September 2023.
NOTE: The latest increase in key ECB interest rates, announced on 14 September, is effective from 20 September.

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7 In Spain, GDP growth increased slightly less than expected in 2023 Q2, owing mainly to the notable drop in exports

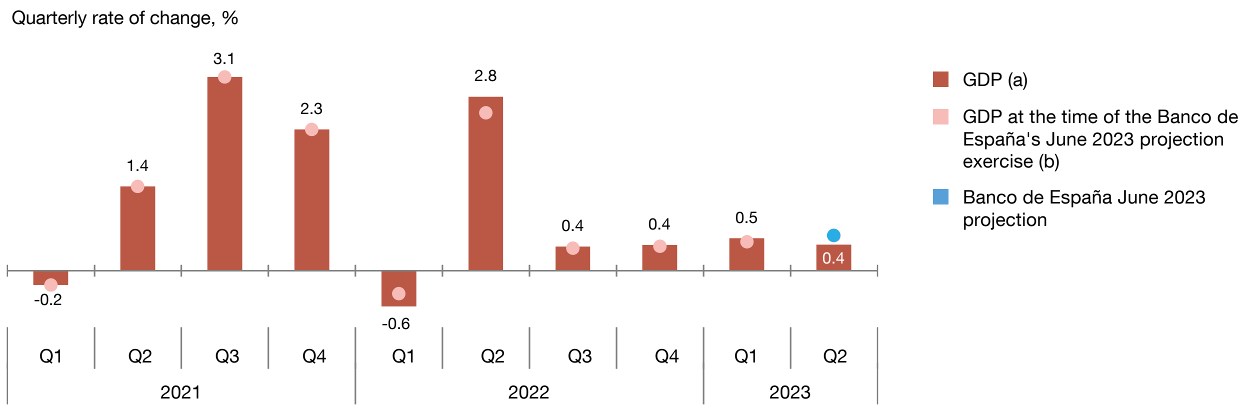
— As per the Quarterly National Accounts (QNA) flash estimate published by the National Statistics Institute (INE) in late July,[2] Spanish GDP grew 0.4% quarter-on-quarter in 2023 Q2, slightly less than envisaged in the Banco de España projection exercise published in June and than recorded in 2023 Q1 (see Chart 7.a).

— According to the INE flash estimate, GDP growth in 2023 Q2 was underpinned by an appreciable increase in domestic consumption and investment, against the background of a significant drop in exports and net external demand making a negative contribution to growth.

— From the supply perspective, the growth between April and June was mainly spearheaded by the services sectors – in particular arts, recreation and other services; information and communication, and non-market services. Conversely, activity levels declined in the primary sector and, to a lesser extent, in industry, energy and real estate services.

Chart 7

7.a Spanish GDP



SOURCES: Banco de España and INE.

a Latest series published by the INE (28 July 2023).
b Latest GDP series available (28 April 2023) at the time of the Banco de España's June 2023 projection exercise. Subsequently, on 23 June, the INE published its second QNA estimate for 2023 Q1, which, relative to the series published on 28 April with the Q1 flash estimate, slightly revised up the quarterly GDP performance for that quarter and the preceding three quarters, and revised down that for 2022 Q1.

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2 This flash estimate also included revised growth rates for previous quarters, having an overall positive carry-over effect on the average GDP growth rate for 2023. For more details, see the Projections in this report.

8 The latest short-term economic indicators suggest that economic growth in Spain may have decelerated slightly in 2023 Q3

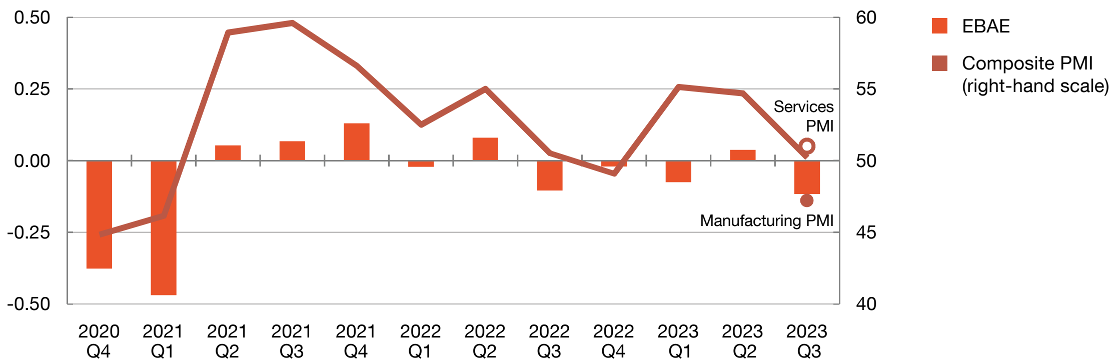
— Against a background of economic slowdown both globally and in the euro area, an overall analysis of the latest available indicators suggests that Spanish GDP could grow by around 0.3% in the period July-September.[3]

— The indicators consistent with a slight slowdown in activity in Q3 notably include the employment and confidence indicators. In particular, both the services and manufacturing PMIs have been in steady decline in recent months, with the latter standing in clear contractionary territory (see Chart 8.a).

— The results of the Banco de España Business Activity Survey (EBAE), which point to a drop in Spanish business turnover in Q3 as a whole, are also consistent with an easing pace of GDP growth in the current quarter.[4]

Chart 8

8.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 Q3 is the average in July and August.

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3 For more details, see the Projections in this report.
4 For more details, see Fernández Cerezo and Izquierdo (2023).

9 Job creation appears to have slowed in Q3, after a highly buoyant start to the year

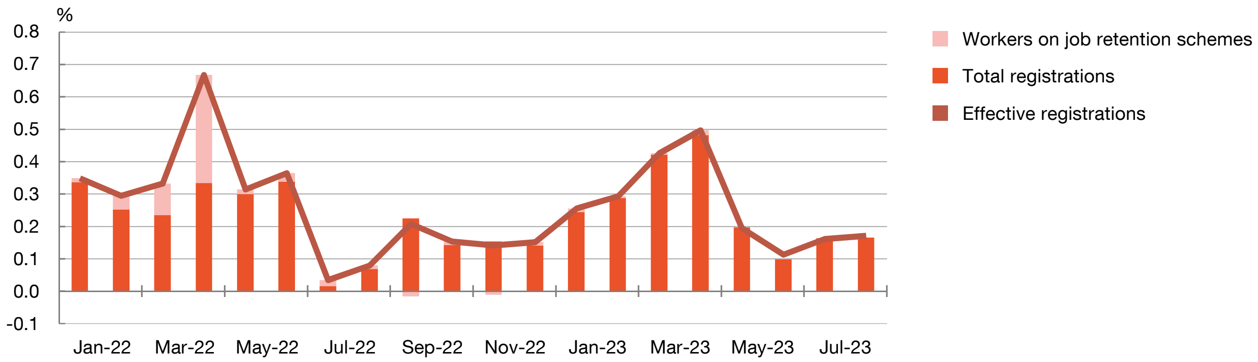
— Social security registrations grew, on a seasonally adjusted basis, by 0.2% in July and August, in line with the growth rates of 0.2% and 0.1% observed in May and June, respectively (see Chart 9.a).

— However, these developments in social security registrations would be consistent with a slowdown in job creation in Q3, after a strong performance in the first four months of the year that enabled the unemployment rate to fall to 11.6% in Q2, its lowest level since 2008 Q3.

— The moderation in employment growth during Q3 has been widespread across sectors of activity. That said, there were notable slowdowns in social security registrations in the construction and market services sectors, although their year-on-year growth rates remain higher than in the industrial sector.

Chart 9

9.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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10 Financing conditions for the Spanish private sector have continued to tighten

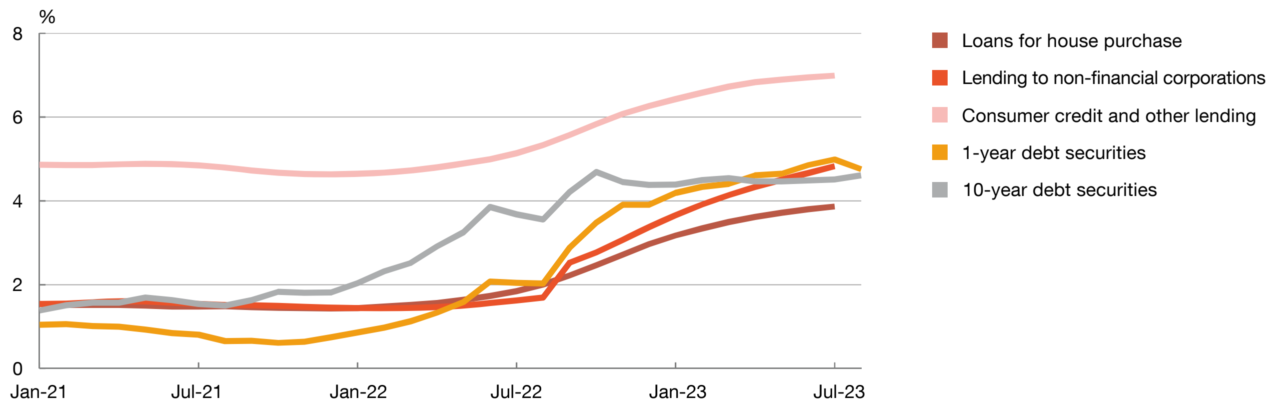
— The cost of new financing to households and firms has continued to increase in recent months, except in the case of short-term corporate debt issues, whose cost fell in August (see Chart 10.a).

— Meanwhile, according to the Bank Lending Survey, both the demand for and supply of credit continued to decline across the board in Q2. Although this reduction was less marked than in the previous quarter, the latest round of this survey suggests a further contraction in credit supply and demand in Q3.

— In this setting, the figures for new financing flows show that, in July, new bank loans to firms lost momentum, while new loans for house purchase continued on the downward path that began in mid-2022. Conversely, both new consumer credit and corporate financing raised through debt securities issuance picked up in July.

Chart 10

10.a Cost of new financing to households and firms (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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11 Private consumption has risen in the summer months, on the back of recreation and tourism-related activities, albeit at a slower pace than in Q2

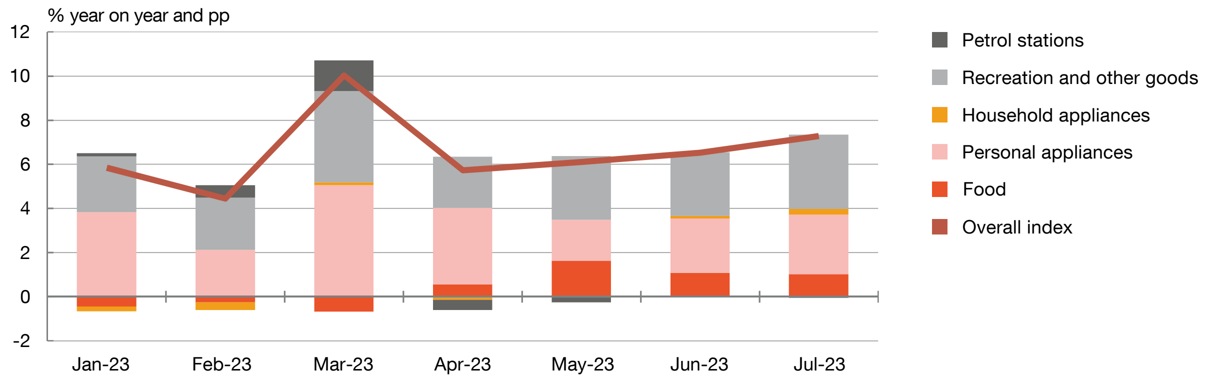
— According to the latest information, household consumption has risen in Q3, driven mainly by recreation and tourism. Thus, retail trade data for July show that the "Recreation and other goods" component is behind almost half of the increase in the overall index during that month (see Chart 11.a).

— On the information provided by the European Commission's economic sentiment indicator, consumer confidence also contributed to the consumption growth in Q3.

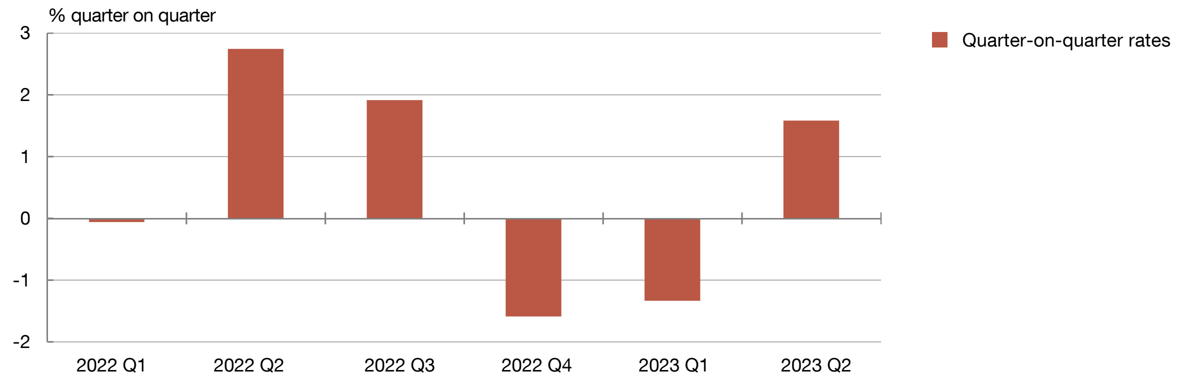
— However, the pace of private consumption growth between July and September (and in the coming quarters) will foreseeably be lower than that recorded between April and June (1.6% according to the flash estimate published by the INE) (see Chart 11.b). This is because growth in this demand component is still appreciably influenced by the tightening of financing conditions and by households' accumulated loss of purchasing power in the last few quarters.

Chart 11

11.a Retail trade: growth and contribution of components



11.b Recent developments in private consumption



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SOURCES: INE and Banco de España.

12 Investment appears to have slackened in Q3, after the sharp rise in the previous quarter

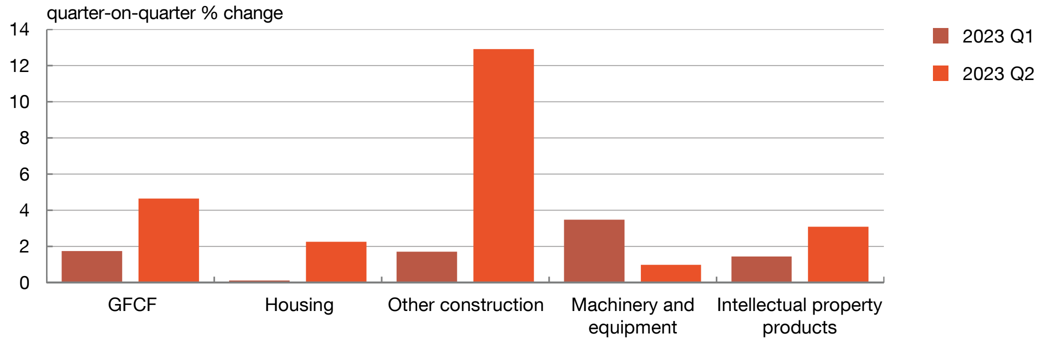
— In Q2, gross fixed capital formation (GFCF) showed considerable vigour and grew by 4.6%, according to the flash QNA estimates published by the INE at end-July. Of note among the investment components was the growth in other construction and intangible capital. Investment in capital goods also increased, albeit somewhat less than expected (see Chart 12.a).

— Looking ahead to the current and coming quarters, the recovery in investment is likely to continue, albeit at a slower pace than in the second quarter. Thus, although business investment growth could be boosted by both the roll-out of the projects under the NGEU programme and the availability of firms' own funds (following the recovery in their gross operating surplus), it would be weighed down to some extent by the tightening of financing conditions in recent quarters and by the recent slowdown in economic activity.

— In the light of these factors and of the most recent developments in the residential construction sector (for example, in the housing construction execution indicator, which has remained on a downward path for the past few months), residential investment is expected to follow a relatively modest growth path. House prices grew 3.6% year-on-year in Q2, in line with the 3.5% seen in the previous quarter, which entailed a 1.4% quarter-on-quarter increase in the seasonally adjusted series.

Chart 12

12.a Recent developments in investment and its components



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SOURCE: INE.

13 Buoyant tourism receipts over the summer months have probably helped to raise net external demand's contribution to growth in 2023 Q3

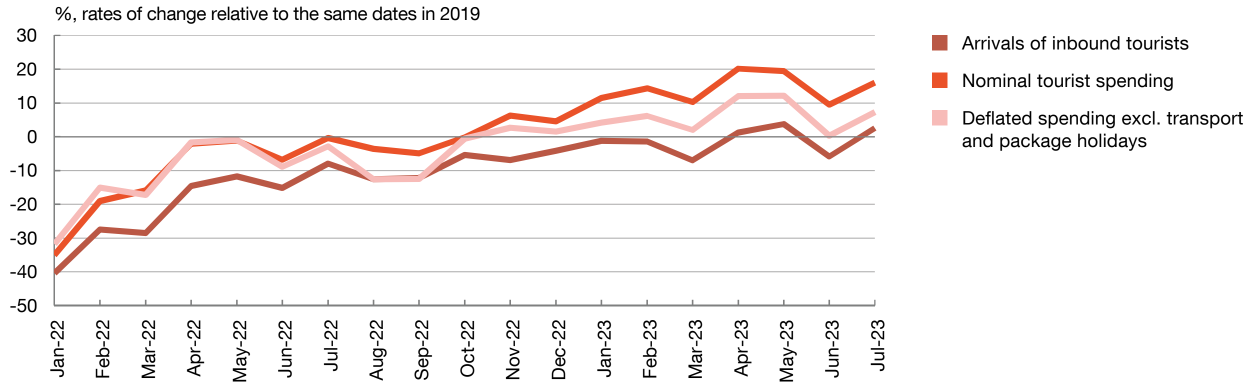
— Net external demand made a large negative contribution (-1.4 pp) to GDP growth in 2023 Q2 against a background of a sharp fall in goods exports (-5.9% quarter on quarter) and an increase in services imports (up by 12.3%).

— However, the contribution of net external demand to GDP growth is likely to have grown in 2023 Q3, especially in the light of robust inbound tourism over the summer. In July, tourist arrivals were 2.6% higher than in the same month in 2019, while spending by non-resident tourists broke July 2019 levels, by 16% in nominal terms and 7.3% in real terms (see Chart 13.a). This increase in spending appears to have been partly driven by the arrival of visitors with higher purchasing power.[5]

— By contrast, in a context of slowing economic activity around the world (especially visible in the manufacturing sector) and in line with the slowdown in activity shown by the PMI indicators, trade in goods with the rest of the world has shown relatively weak momentum so far in 2023 Q3.

Chart 13

13.a Indicators of inbound tourism. Rates of change relative to pre-pandemic levels



SOURCES: INE and Banco de España.

5 For more details, see García, Gómez Loscos and Martín Machuca (2023).

14 In spite of increasing spending, the public deficit has continued to fall in recent months thanks to strong revenue growth

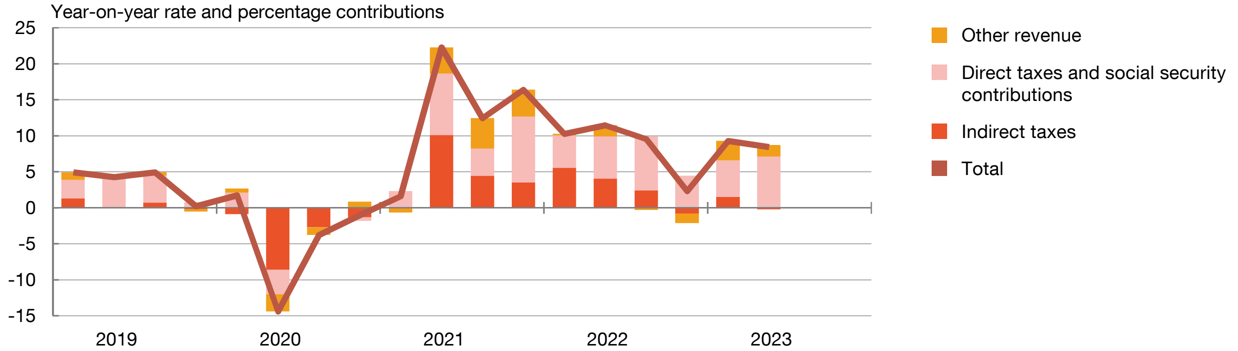
— After the slowdown seen in the last few months of 2022, public revenues stepped up significantly in 2023 H1 (see Chart 14.a). This was mainly owing to the nominal rise in income, which boosted direct tax revenues and social security contributions.[6] Conversely, indirect tax revenues have been sluggish so far in 2023 and have grown slower than would be expected based on their drivers.

— Meanwhile, spending growth in 2023 H1 was higher than in 2022 as a whole, owing to the sharp rise in social benefits caused by the pension revaluation and, to a lesser extent, to growing government consumption (see Chart 14.b).

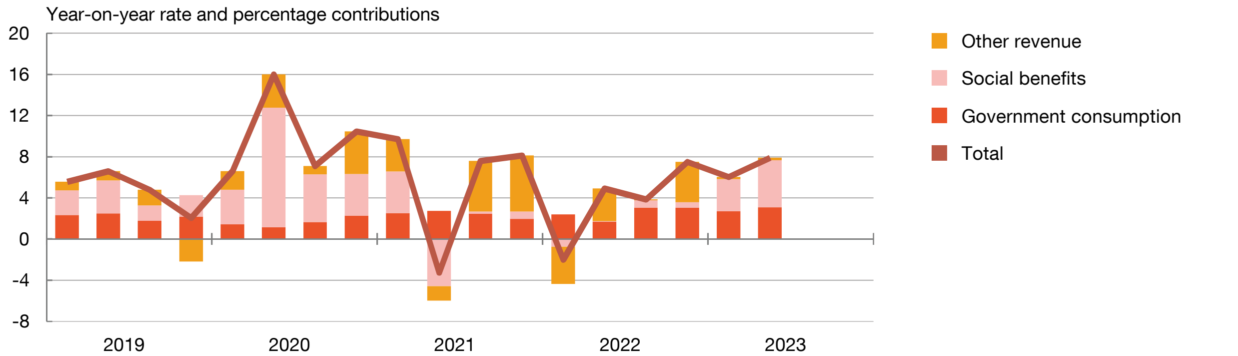
— As a result, the 12-month cumulative general government balance stood at -4.4% of GDP in June, 0.4 pp better than at end-2022.

Chart 14

14.a Change in government revenue (a)



14.b Change in government spending (a)



SOURCES: Banco de España and IGAE.

a Data from 2023 Q2 are overall general government figures, not including local government, and excluding transfers between general government units.

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6 This change was also affected by the measures approved by the Government, which would appear to have had a positive net impact of 0.7 pp on the growth rate of revenues (resulting from a positive impact of 1.5 pp linked to tax and social security contribution rises and a negative impact of 0.8 pp linked to tax cuts implemented in response to the energy crisis).

15 Headline inflation picked up somewhat in July and August, influenced by rising oil prices and various base effects

- The moderating path of headline inflation that began in August 2022 brought down the annual growth rate of the HICP to 1.6% in June. Headline inflation has picked up again since then, to 2.1% in July and 2.4% in August (see Chart 15.a).

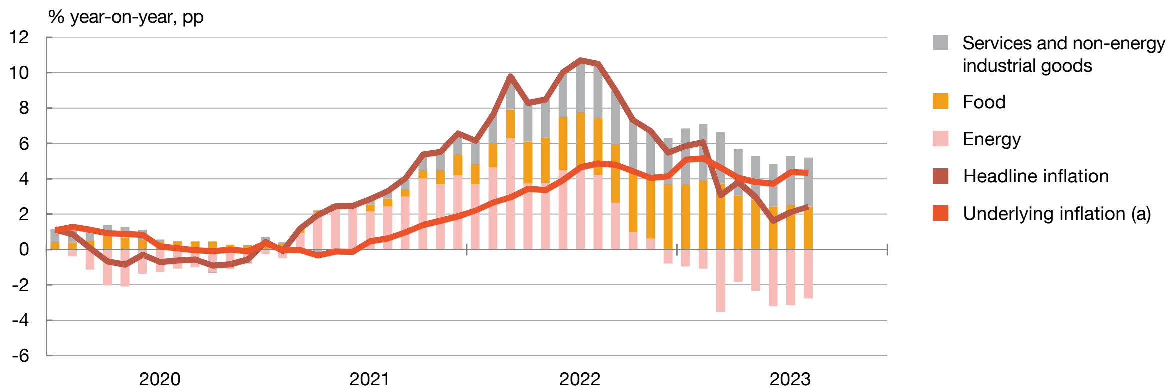
- This uptick is mainly an effect of the moderation of the pace of decline of energy prices, which are the consequence of both the recent (higher-than-expected) rise in crude oil prices on international markets and the base effects linked to the declines in oil derivatives prices in 2022 Q3.

- Turning to food, although some products (such as olive oil and some fruits and vegetables) have come under additional inflationary pressure in recent months owing to adverse weather conditions, food price inflation in general has continued to ease recently. This slowdown is relatively widespread and by August had affected 70% (in terms of their weight in the consumption basket) of the HICP's food components.

- Underlying inflation picked up in July, contributing to the rise in headline inflation, before moderating somewhat in August because of price rises in the components relating to recreation, hospitality and tourism (consistent with the vigorous performance of these segments over the summer) and also the lesser impact of the summer sales on prices (owing to the annual revision of the weightings, which cut the weight of clothing and footwear in the consumer basket in early 2023).

Chart 15

15.a Inflation in Spain: change and contribution of components



SOURCES: Eurostat and Banco de España.

a Headline inflation, excluding energy and food.

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16 Wage settlements continued to rise somewhat in the summer months against a backdrop of a significant pick-up in non-wage costs

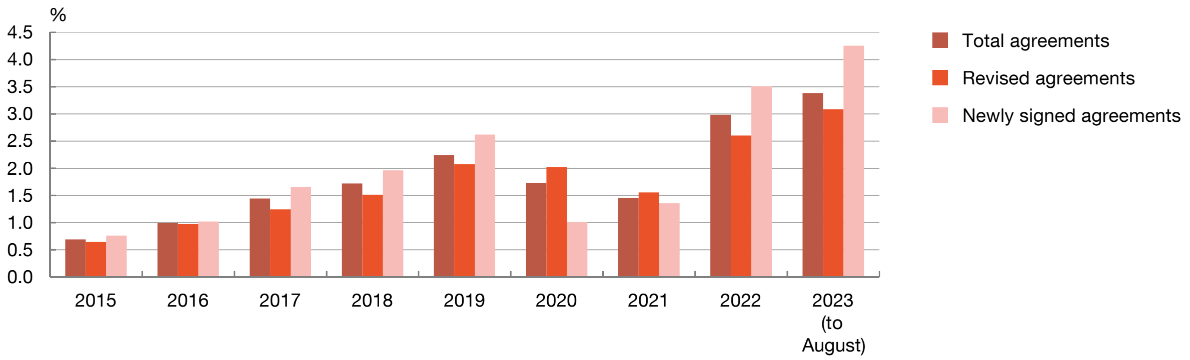
— Based on data to August, wage settlements agreed for 2023 stand at 3.4%, with the previous year's figure standing at 2.9% (see Chart 16.a). However, new collective agreements signed in 2023, which already affect nearly 2.5 million workers, show an increase (4.3%).

— In any case, compensation per employee in the market economy has risen faster than negotiated wage increases in collective agreements, rising 6.3% in Q1 and 4.6% in Q2. According to the quarterly labour costs survey, these rises are the result of changes in both non-wage costs and ordinary wage costs.

— Non-wage costs rose by 7.4% in 2023 H1, mainly owing to higher social security contributions.[7] In the same period, ordinary wage costs grew by 5.6%, faster than negotiated wage settlements in collective agreements. Among other things, this may reflect wage increases as a result of job changes. The difference between the rise in ordinary wage costs and negotiated wage settlements tends to be greater in sectors with higher employment buoyancy and/or more severe labour shortages – as in the information and communication sector, for example.

Chart 16

16.a Wage settlement



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SOURCE: Ministerio de Trabajo y Economía Social.

7 In particular, owing to the rise in both the maximum and minimum social security contribution bases (by 8.6% in the first case and by 8% in the second case, following the minimum wage hike, as well as the 0.6 pp increase in the social security contribution rate as a result of the entry into force of the intergenerational equity mechanism.

17 Profit margins appear to have moderated somewhat in 2023 H1, albeit unevenly across sectors

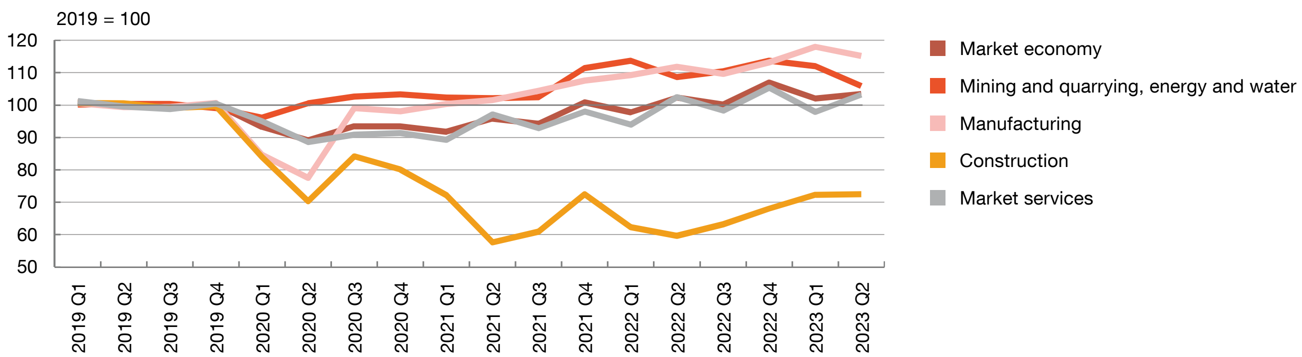
— According to the provisional National Accounts data for 2023 Q2, the ratio of gross operating surplus (GOS) to gross value added (GVA) in the market economy appears to have moderated slightly in the first half of the year, following the upturn seen in late 2022 (see Chart 17.a). In any event, this overall trend masks a significant degree of heterogeneity across sectors, owing, at least partially, to differences in the strength of demand from sector to sector.

— In aggregate terms, this is consistent with the behaviour of the ratio of gross operating profit (GOP) to GVA observed in the sample of firms in the Banco de España's Central Balance Sheet Data Office Quarterly Survey (CBQ).

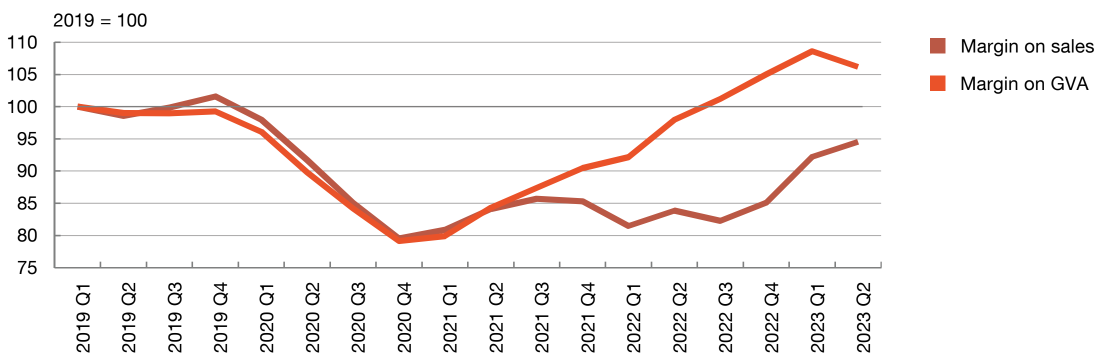
— Meanwhile, in the CBQ, profit margins (proxied as the ratio of GOP to turnover) continued to rally, albeit still falling short of pre-pandemic levels (see Chart 17.b).

Chart 17

17.a Changes in profit margins (GOS/GVA) according to National Accounts data. Breakdown by sector



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



SOURCES: Banco de España and INE.

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. Four-quarter cumulative data.

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18 The Banco de España's latest macroeconomic projections revise GDP growth for 2024 downwards and headline inflation for 2023 and 2024 upwards

— 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%, 1.8%, and 2.0% in 2023, 2024 and 2025, respectively. The current projections hold the growth rate forecast for 2023 unchanged from the projections published in June, as a result of factors that exert opposing pressures on growth and data that offset each other.[8] However, the growth rates for 2024 and 2025 are revised downwards by 0.4 pp and 0.1 pp, respectively, mainly due to the projections' new underlying assumptions, which entail a rise in energy prices, a worsening external environment and a further tightening of financing conditions.

— Meanwhile, compared with the June projections, the average headline inflation rate is revised upwards by 0.4 pp for 2023 (to 3.6%) and by 0.7 pp for 2024 (to 4.3%). For 2023, this revision primarily owes to the rise in oil prices during the summer. In 2024, it owes mainly to the higher cost of energy according to the futures markets, but also, to a lesser extent, to the effects on inflation entailed by the renewal until end-2023 of the lower VAT on food and of the public transport subsidy.

— The risks to these projections are tilted to the downside with regard to activity and balanced with respect to inflation.

Figure 1

	2023	2024	2025
GDP	2.3% =	1.8% ↓ 0.4 pp	2.0% ↓ 0.1 pp
Inflation	3.6% ↑ 0.4 pp	4.3% ↑ 0.7 pp	1.8% =

SOURCE: Banco de España.

8 On the one hand, the latest QNA data up to 2023 Q2 published by the National Statistics Institute (INE) in late-June entail a slight positive carry-over effect on GDP growth this year. On the other, on the latest short-term economic information, the downward revision to the growth forecast for H2 has a slightly negative carry-over effect.

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 5.8% in real terms in 2022 – is projected to rise by 2.3%, 1.8% and 2% 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 3.6% in 2023 and increase slightly to 4.3% 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 2.3% and 1.7% over the next two years.

Activity

In 2023 Q2 GDP growth in Spain was somewhat lower than projected by the Banco de España in June. Specifically, according to the flash estimate published by the National Statistics Institute (INE), quarter-on-quarter GDP growth decreased by 0.1 pp, to 0.4%, 0.2 pp below that projected by the Banco de España in June.[2] GDP growth during this period was underpinned by domestic demand, which contributed 1.9 pp, following the negative contributions in the two previous quarters. Within this aggregate, growth in consumption and investment in non-residential construction was particularly notable. Conversely, net external demand deducted 1.4 pp from growth, as a result of a sharp contraction in exports, concentrated in the goods and non-travel services components, which was more pronounced than that observed in imports.

When the INE published the flash estimate for 2023 Q2, it also revised the seasonally adjusted historical data of the QNA. This gave rise to a downward revision of GDP growth in 2022 Q1 and to slight upward revisions in the following four quarters. As a result of the historical data revision and GDP growth in Q2, the starting point for activity in the current projection exercise is somewhat more favourable than was anticipated in June. Specifically, all of this new information has a positive carry-over effect (of 0.1 pp) on GDP growth in the current year.

1 The current projections incorporate the new information that has become available since the publication of the previous projections – on 19 June – until 8 September, the cut-off date for this exercise. Specifically, the new information includes the Quarterly National Accounts (QNA) flash estimate for 2023 Q2 (which also entailed significant revisions to the data for preceding quarters), the Quarterly Non-Financial Accounts for the Institutional Sectors for 2023 Q1 and the higher-frequency information that has come to light since the cut-off date for the June projections. The projections also factor in the changes observed to 8 September in the technical assumptions used as a starting point for projecting the different macroeconomic aggregates (see Table 2). The exception is the assumptions regarding export market developments, which are taken from the September European Central Bank (ECB) staff macroeconomic projections for the euro area, with cut-off date of 22 August. Meanwhile, the National Statistics Institute (INE) released a revision of the Annual National Accounts (ANA) series on 18 September (one day before the publication of these projections). This information has not been included in the projections as it was not available before their cut-off date. Nevertheless, it would not have been possible to use these data consistently in the current projection exercise, since the methodological procedures used by the Banco de España in preparing its projections are based on quarterly series, and the quarterly series consistent with the new annual data will not be available until 22 September. In any case, the 2022 GDP growth rate of 5.8% referred to in the text corresponds to the revised ANA figure, as opposed to the 5.5% reported in the previous series.

2 "Macroeconomic projections for the Spanish economy (2023-2025)". *Economic Bulletin - Banco de España,* 2023/Q2.

Table 1
Macroeconomic projections for the Spanish economy (a)

Annual rate of change (%)

	GDP				HICP				HICP excluding energy and food				Unemployment rate (% of labour force) (b)			
	2022 (c)	2023	2024	2025	2022	2023	2024	2025	2022	2023	2024	2025	2022	2023	2024	2025
September 2023	5.5	2.3	1.8	2.0	8.3	3.6	4.3	1.8	3.8	4.1	2.3	1.7	12.9	12.0	11.5	11.3
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

SOURCES: Banco de España and INE.
NOTE: Latest QNA figure published: 2023 Q2.

a Projections cut-off date: 8 September 2023.
b Annual average.
c The new GDP growth figure for 2022 would stand at 5.8%, instead of the 5.5% reflected in the table, following the revision to the Annual National Accounts time series for 2020-2022 published by the INE after the cut-off date for the projections (18 September).

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

Annual rate of change (%), unless otherwise indicated

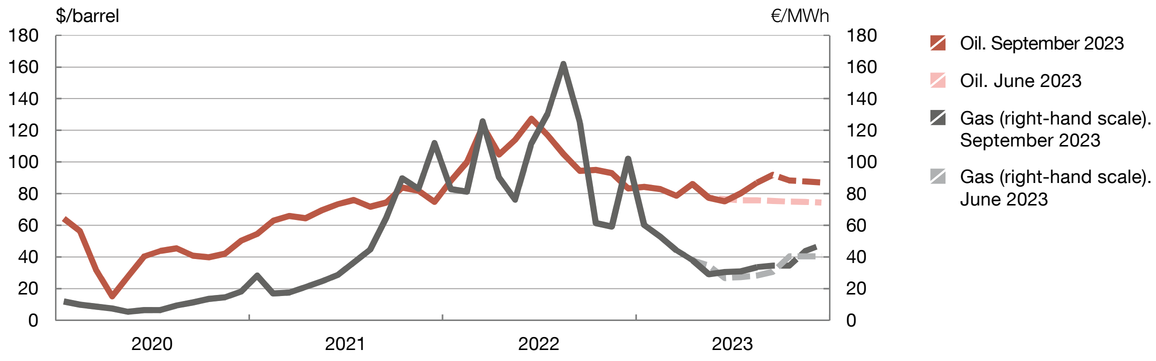
		September 2023 projections			Difference between the current projections and the June 2023 projections (b)		
	2022	2023	2024	2025	2023	2024	2025
Spain's export markets (c)	8.0	0.3	2.6	2.8	-0.5	-0.5	-0.1
Oil price in dollars/barrel (level)	103.7	83.8	83.5	78.8	5.8	10.9	8.4
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1.05	1.08	1.08	1.08	0.00	-0.01	-0.01
Nominal effective exchange rate against non-euro area countries (d) (2000 = 100)	112.1	115.7	115.7	115.7	0.3	0.1	0.1
Short-term interest rate (3-month EURIBOR; level) (e)	0.3	3.4	3.6	3.0	0.0	0.2	0.1
Long-term interest rate (10-year Spanish government bond yield; level) (e)	2.2	3.5	3.7	3.8	0.0	0.1	0.0

SOURCES: ECB and Banco de España.

a Cut-off date for assumptions: 22 August for Spain's export markets and 8 September 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 September 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.

Chart 1

1.a Energy prices



SOURCES: Mercado Ibérico del Gas and Reuters.

The tightening of financing conditions continued to be a drag on growth during the summer months. Although global monetary policy tightening has continued to slow down in recent months, the international financial markets have started to assume, in line with the persistence of considerable underlying inflationary pressures and the messages conveyed by the world's main central banks, that interest rates will remain relatively high for longer than expected a few months ago. This seems to have contributed to a rise in long-term interest rates during Q3. In parallel, in the Spanish economy, the cost of servicing the outstanding balances of existing variable-rate debt and the cost of refinancing past-due balances have continued to rise. This appears to be exerting increasing pressure on indebted agents' income. Also, the cost of new bank lending has continued to increase in recent months. This, together with the fresh tightening of credit standards, seems to have negatively impacted the volume of new loans to firms and to households for house purchase.[3]

A worsening of the external economic environment and a surge in energy prices have also been observed during the summer. Indeed, according to the latest indicators available, global economic activity has been slowing down over the last few months. This is particularly evident in China and the euro area (by geographical area) and in the manufacturing sector (by sector of activity). Furthermore, as a result of the materialisation of different negative supply shocks at international level, oil and natural gas prices have recently risen more than expected a few months ago. These increases have also been observed in the Spanish economy (see Chart 1).

Against this backdrop, Spanish economic growth appears to have moderated somewhat in 2023 Q3. Pointing in this direction, in particular, are Social Security registrations, which grew at a slightly slower pace in July and August than in Q2, and the results of the latest edition of the Banco de España Business Activity Survey (EBAE, by its Spanish acronym), which suggest a

3 Conversely, consumer credit has shown some strength recently. This could signal that some household groups are facing growing difficulties as regards carrying out their decisions to purchase goods and services using their current income and accumulated savings.

weakening of business turnover in this period (Fernández Cerezo and Izquierdo, 2023). In addition, the Purchasing Managers' Indices (PMIs) show that the growing weakness in industry has also been accompanied by the emergence of signs of a loss of momentum in the services sector in the final stretch of the quarter. The services sector, however, continues to be comparatively more buoyant than manufacturing, especially in activities connected to leisure and tourism. Overall, with the caveat that the information available is incomplete, quarter-on-quarter GDP growth in Spain in Q3 is estimated at around 0.3%.

Looking ahead to the coming quarters, activity is expected to continue to show relatively subdued growth, influenced by the effects of various factors operating in opposite directions and with a different timing. These factors include most notably:

— The continuation of the **pass-through of monetary policy tightening** to the cost of new loans and the interest burden of borrowers, which will still adversely impact the GDP growth rate over much of the projection horizon.

— The weak **external environment,** which will also weigh on economic activity in Spain in the final stretch of the year. However, Spanish goods exports will be boosted from 2024 by the expected recovery in external markets and the competitiveness gains over the rest of the euro area stemming from the greater labour cost moderation in Spain of late. **Inbound tourism** has contributed very positively to GDP growth in recent quarters and will also foreseeably continue to do so in Q3 and in the short term. However, as tourism exports have already recovered their pre-pandemic levels, their contribution to GDP growth should be expected to taper off in the longer term.

— The **public policies adopted in response to the energy crisis** and to rising inflation, which will continue to underpin activity in the remainder of the year. However, these measures eventually being withdrawn at the end of 2023 (according to the timetable announced) will hold Spanish economic growth back over the rest of the projection horizon, especially in 2024.

— Conversely, in the period 2024-2025 the Spanish economy will be increasingly bolstered by the gradual **softening of inflationary pressures,** the **progressive recovery in agents' confidence, labour market resilience** and the expected pick-up in the **roll-out of projects under the Recovery and Resilience Facility,** among other factors.

Considering all these factors, the annual average rate of GDP growth is expected to moderate substantially this year and have a relatively flat profile over the subsequent two-year period. GDP will grow by 2.3% in 2023, down 3.5 pp on 2022. As in Q2, domestic demand will continue, in the remainder of the year, to be the main driver of growth. However, in the year overall, the contributions of the external sector and domestic demand to output growth will be similar (see Table 3 and Chart 2). GDP will grow at around 2% in 2024-2025, essentially underpinned by private consumption and, to a lesser extent, gross fixed capital formation. The external sector will make practically zero contribution to growth in 2024 and 2025. In the labour market,

Table 3

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

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

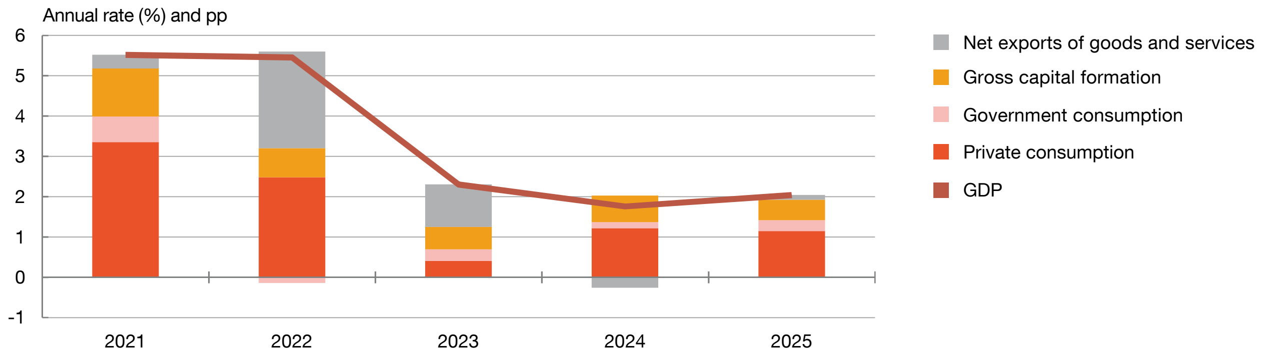
		September 2023 projections			June 2023 projections		
	2022	2023	2024	2025	2023	2024	2025
GDP	5.5	2.3	1.8	2.0	2.3	2.2	2.1
Private consumption	4.4	0.7	2.2	2.0	0.2	3.3	2.0
Government consumption	-0.7	1.4	0.8	1.4	0.6	0.8	1.3
Gross fixed capital formation	4.6	3.1	3.4	2.4	1.7	4.1	2.8
Exports of goods and services	14.4	4.0	2.2	3.0	7.1	2.2	3.0
Imports of goods and services	7.9	1.5	3.2	3.0	3.2	4.0	3.1
Domestic demand (contribution to growth)	3.1	1.2	2.1	1.9	0.6	2.8	2.0
Net external demand (contribution to growth)	2.4	1.1	-0.3	0.1	1.7	-0.6	0.1
Nominal GDP	10.0	7.6	5.1	3.8	6.8	5.4	4.1
GDP deflator	4.3	5.2	3.3	1.7	4.4	3.2	2.0
HICP	8.3	3.6	4.3	1.8	3.2	3.6	1.8
HICP excluding energy and food	3.8	4.1	2.3	1.7	4.1	2.1	1.7
Employment (hours)	4.1	1.3	1.5	1.3	1.7	1.8	1.1
Unemployment rate (% of labour force). Annual average	12.9	12.0	11.5	11.3	12.2	11.5	11.3
Net lending (+) / net borrowing (-) of the nation (% of GDP)	1.5	5.0	4.1	3.3	4.8	3.9	3.5
General government net lending (+) / net borrowing (-) (% of GDP)	-4.8	-3.7	-3.4	-4.1	-3.8	-3.4	-4.0
General government debt (% of GDP)	113.2	108.8	106.9	107.9	109.7	107.4	108.0

SOURCES: Banco de España and INE.
NOTE: Latest QNA figure published: 2023 Q2.

a Projections cut-off date: 8 September 2023.
b The figures for 2022 do not include the revision to the Annual National Accounts for 2020-2022 released by the INE after the projections cut-off date (18 September).

Chart 2

2.a GDP growth and contributions of main components (a)

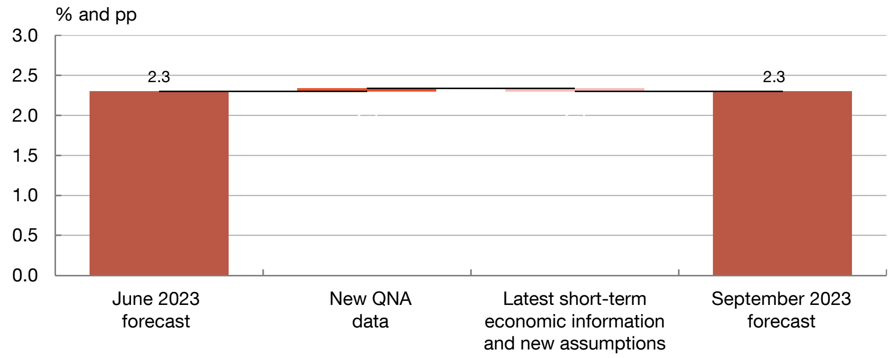


SOURCE: INE.

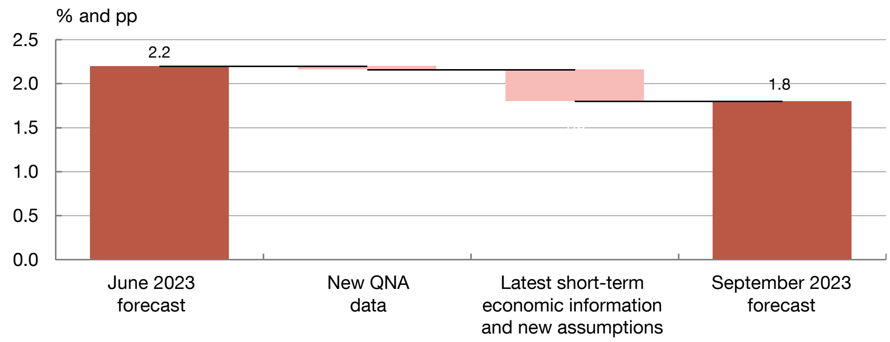
a Following the release of the INE's revised Annual National Accounts time series for 2020-2022 after the projections cut-off date (18 September), the figures for GDP growth and its components in 2021 and 2022 have changed and differ from those depicted in this chart.

Chart 3

3.a Changes in the GDP growth forecast for 2023



3.b Changes in the GDP growth forecast for 2024



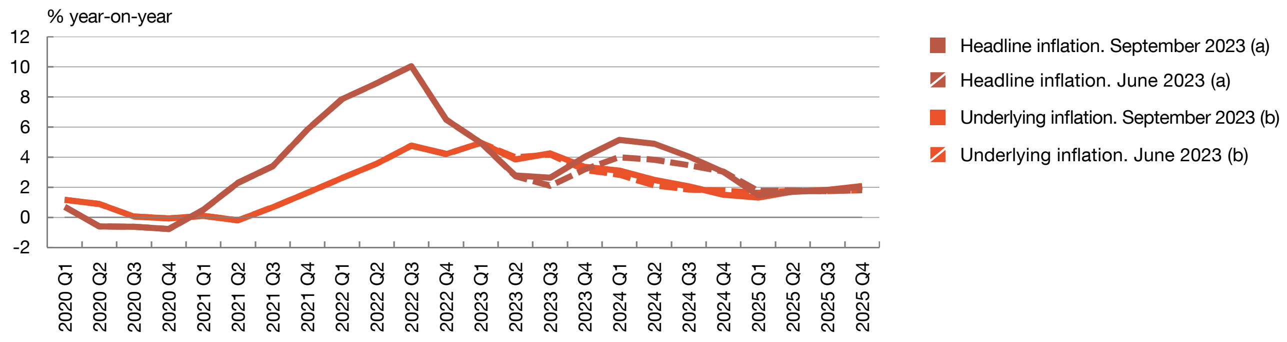
SOURCES: INE and Banco de España.

employment will remain highly buoyant this year (with the number of persons employed growing by 2.6%), but decelerate in 2024 and 2025, in line with the projections for activity, although apparent labour productivity will recover slightly. At the end of the projection horizon, the number of hours worked per person will remain below its 2019 level, reflecting the historically downward trend of this variable. Continued job creation explains the projected decline in the unemployment rate, which will stand at around 11% on average in 2025, amid sustained labour force growth, benefitting from the population growth associated with migratory flows.

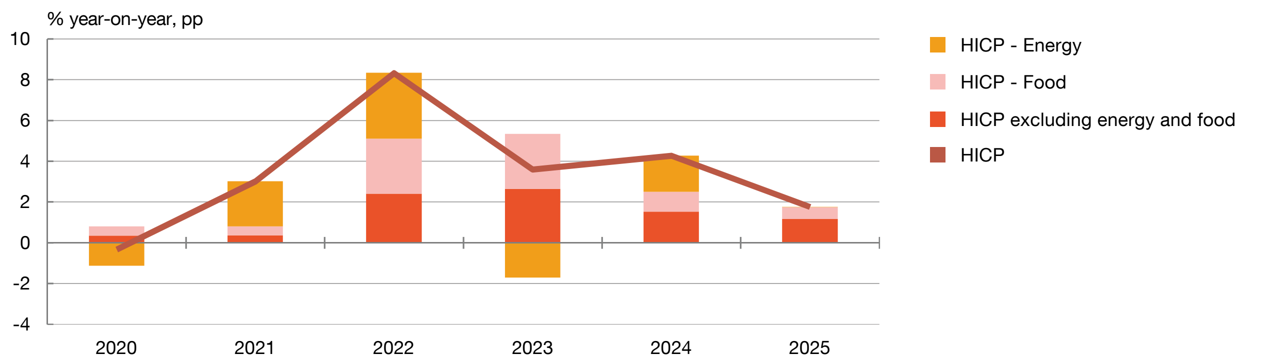
Compared with the June projections, GDP growth remains unchanged in 2023, but is revised down in 2024 and 2025. The unchanged projected growth rate for this year is due to a combination of different factors with opposite effects (see Chart 3.a). On the one hand, as mentioned above, the latest QNA data entail a 0.1 pp upward revision to the annual average GDP growth rate in 2023. On the other, however, estimated growth for 2023 H2 is now somewhat lower than projected in June, as a result of the latest short-term economic information and the new technical assumptions underlying these projections. In particular, the new assumptions entail higher energy prices, higher interest rates and less favourable export market developments for activity growth (see Table 2 and Annex 1). Meanwhile, the GDP growth rate projected for 2024 is now 0.4 pp lower than in June. Most of this revision (just over 0.3 pp) is due to activity now being

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.

expected to perform worse in 2023 H2 – which has a negative carry-over effect on average growth for 2024 – and to the change in the technical assumptions, especially as regards the higher energy prices, but also, to a lesser extent, the deterioration in the external environment and the greater tightening of financing conditions. The remainder (just under 0.1 pp) is the result of the negative carry-over effect on output growth in 2024 stemming from lower GDP growth in 2023 Q2 than envisaged in the June Banco de España projections (see Chart 3.b). Lastly, the relatively slight downward revision to the GDP growth rate projected for 2025 is mainly the result of the negative carry-over effect on that rate of the less buoyant activity now expected for 2024.

Prices and costs

Headline inflation has increased slightly over the summer. Specifically, the year-on-year rate of change of the harmonised index of consumer prices (HICP) stood at 2.4% in August, having fallen to 1.6% in June, its lowest level since April 2021 (see Chart 4.a). By component, this increase reflects an easing of the pace of the year-on-year drop in energy prices, on account of the recent higher oil prices on international markets and the base effects stemming from the decline in energy product prices in 2022 Q3.

The deceleration in food prices initiated in late 2023 Q1 has continued in recent months. The slowdown in these prices has been relatively widespread. However, adverse weather conditions have exerted further inflationary pressures on some products (such as olive oil and certain fruits and vegetables) in recent months.

Similarly, underlying inflation has eased in 2023 to date. However, the deceleration has tended to level off over the summer months. In particular, underlying inflation increased in July and August compared with the rates recorded in the spring. This increase was partly the result of some temporary technical factors.[4] Yet it also stemmed from the relative momentum of leisure, hospitality and travel services prices, driven by considerably robust demand in these sectors over the summer.

In the short term, the path of headline inflation will be influenced by the behaviour of the energy component. The HICP energy index is expected to fall to a year-on-year rate close to 20% on average in 2023 Q3. However, the recent increase in the corresponding commodity prices (oil particularly), combined with the base effects stemming from drops in these products' prices in late 2022, means that the year-on-year rate of change of this component will fall to close to 0% in Q4. In addition, the assumption in these projections about the main measures rolled out by the authorities to mitigate the effects of the energy crisis being withdrawn in late 2023 will contribute to the increase in the pace of growth of energy prices extending into the early quarters of 2024, to stand at close to 25% in the spring. Given the path of energy prices on futures markets, energy inflation will start to ease in the final stretch of 2024, falling to practically zero at the end of the projection horizon.

Food inflation will follow a downward path over the coming quarters. The expected deceleration is explained by the decline in the costs of some production inputs, such as energy and fertilisers, after they surged during much of 2022. However, the extent of food price moderation will tend to be limited by the negative impact that adverse weather conditions could have on the production of certain agricultural goods in some geographical areas and, probably, by Russia's withdrawal from the Black Sea Grain Initiative. In any event, despite the idiosyncrasy of the different determinants of the current food price cycle, the recent deceleration in food prices generally appears to be in line with that observed historically following other episodes of rising prices.

Moreover, underlying inflation will slow from the final stretch of 2023 (see Chart 4.a). This will reflect the gradual impact of monetary policy tightening on demand, the easing of the inflationary pressures stemming from the post-pandemic reopening of the economy, and the

4 Specifically, the annual revision to the weights of the different goods and services in the index at the beginning of the year led to clothing and footwear items having a lower weight, which has reduced the effect of the summer sales in these items on headline HICP.

progressive, albeit somewhat lagged, pass-through of lower energy costs to the prices of non-energy industrial goods and services. Among the components of underlying inflation, the slowdown over the coming quarters is expected to be more pronounced in non-energy industrial goods than in services – as it has been so far this year – in line with the stronger demand for services (particularly for more contact-intensive services) and the differing cost structures of the productive sectors. Specifically, in the case of non-energy industrial goods, inputs account for a larger relative share of costs and their prices have begun to decline year-on-year over the course of the year; in the case of services, however, wages account for a greater share of the costs and are rising somewhat.

As a result, in terms of annual average rates, headline inflation in 2023 will moderate considerably from the rate of 8.3% in 2022, to then rebound in 2024 and fall back to below 2% in 2025. The annual average increase in the HICP will stand at 3.6% in 2023 and rise to 4.3% in 2024 owing to the greater contribution of the energy component, which will more than offset the expected reduction in food and underlying inflation for that year (see Chart 4.b). The stabilisation of the energy HICP and the continued disinflation in the non-energy HICP will result in headline inflation of 1.8% in 2025. Meanwhile, underlying inflation is expected to run at 4.1% in 2023 and to then ease to 2.3% in 2024 and 1.7% in 2025.

This inflation outlook rests on two key assumptions. First, in line with the empirical evidence available, some asymmetry in the pass-through of energy price changes 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. This leads to some downward stickiness in underlying inflation, which appears to have been made stickier still by the recent rise in oil prices. Second, in line with developments to date, it is assumed that no significant second-round effects – via wages or profit margins – that might trigger a wage-price spiral will emerge over the projection horizon.

As compared with those published in June, the current projections revise up headline inflation in 2023 and 2024. Specifically, average headline inflation for these years is now expected to be 0.4 pp and 0.7 pp higher, respectively, than projected in June. For 2023, this primarily owes to the rise in oil prices observed during the summer. In 2024, it owes mainly to the higher cost of energy and, to a lesser extent, the effects on inflation for the year of the assumption regarding the renewal of the VAT rate reduction on food stuffs and of the public transport subsidy until end-2023.

Risks

Against a backdrop in which uncertainty remains very high, the risks to the projections are considered to be tilted to the downside for economic growth and balanced for inflation. The main risk factors relating to the projected GDP path stem from global economic activity potentially faring worse than considered in the underlying assumptions (associated specifically with a more pronounced slowdown in the Chinese economy) and from the tighter financing conditions having a potentially more severe impact on activity than envisaged in the baseline scenario (in turn, lowering the inflation path). Further, there is a risk that a hypothetical escalation in geopolitical tensions (for example, in the context of the war in Ukraine) could exert upward pressure on energy and food commodity prices and even disrupt the availability of these goods. Such a scenario would lead to a rise in inflation and a downturn in activity.

As a rule, quantifying the scale and timing of the impact of monetary policy tightening on activity and prices is a considerably complex exercise. One reason for this is that monetary policy operates with a lag whose duration is uncertain. In the current episode, such difficulties are also exacerbated by monetary tightening having been, like the surge in inflation, unusually rapid, intense and globally synchronised. In these circumstances, it is particularly hard to determine the appropriate dosage of monetary tightening, as a stronger-than-expected transmission of monetary policy would lead to a larger contraction in aggregate demand and, therefore, a lower inflation path.

A larger-than-expected increase in wages or profit margins would push the inflation path higher. So far, the easing of underlying inflation is proving modest in both Spain and, above all, other jurisdictions. Until a downward trend in underlying inflation becomes more firmly entrenched, the emergence of second-round effects on prices via wages and/or profit margins cannot be ruled out, especially amid substantially robust demand for labour. Such a scenario in the euro area overall could call for more forceful monetary policy action, leading to a further tightening of financing conditions and, therefore, a greater weakening of private agents' spending.

There are also other sources of uncertainty surrounding activity and prices on the domestic front. In particular, there are doubts as to the capacity of the household savings built up during the pandemic to support private consumption over the coming quarters, and as regards the pace at which the NextGenerationEU projects will be rolled out and their impact on activity. Another significant risk is that stemming from the persistence of the high structural budget deficit and public debt, amid rising borrowing costs and the reactivation of European fiscal rules.

Annex 1
Assumptions underlying the projections

In comparison with the June projections, the technical assumptions used as a starting point for the current projection exercise are somewhat less favourable for activity. Specifically, the new assumptions entail a downward revision to the growth of Spain's export markets, particularly in 2023 and 2024, and higher energy prices as regards gas and, especially, oil (see Table 2). Money market rates and sovereign debt yields expected by financial markets in the coming years are currently somewhat higher than they were three months ago. In line with this, new lending is now also expected to cost slightly more over the projection horizon than forecast three months ago. Lastly, the nominal effective exchange rate is now stronger.

The fiscal assumptions remain largely the same as in the June projections. As regards new measures, Royal Decree-Law 5/2023 of 28 June 2023 renewed, until the end of the year, some of the measures adopted in response to the economic and social consequences of the war in Ukraine, with an estimated impact on the general government deficit of 0.1 pp of GDP. Meanwhile, the latest data on actual revenue and expenditure for this year suggest the deficit for 2023 will be somewhat narrower than projected in June. Further, in the absence of new material information, the expected path of expenditure financed with European funds from the Recovery and Resilience Facility (RRF) is unchanged from the previous projection exercise.[5] Nevertheless, the uncertainty surrounding this path remains very high.

For the other budget items, the projections are based on the standard technical assumptions. As in previous exercises, the projections continue to assume that the upward surprises in tax revenue observed in 2020-2021 will partially reverse over the projection horizon, that the support measures approved during the energy crisis will be withdrawn in early 2024 and that the temporary revenue-raising measures will not be renewed further than currently approved.[6]

5 As a percentage of GDP, expenditure financed with RRF funds is expected to be slightly above 1% in 2023, to peak at around 1.3% in 2024 and to fall back to around 1% in 2025.

6 The 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.