

Foreword by the Governor

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The Banco de España's *Annual Report* takes stock of the developments in the Spanish economy in 2023 and in 2024 to date, setting them against the global and European context, and assesses the outlook and the main risks in the short and medium term (see Chapter 1). Taking a longer perspective, this report spells out the main structural challenges facing Spain and that have continued to hamper convergence with the euro area in recent decades, and the policies and reforms needed to make up for lost time (see Chapter 2).

The report also includes two thematic chapters. Chapter 3 focuses on the Spanish labour market, reviewing its recent developments, before analysing the challenges associated with the technological and demographic changes under way (which are common to other advanced economies) and discussing labour market policies as they currently stand and possible avenues to improve them so as to tackle both these and the more idiosyncratic challenges within the Spanish labour market (e.g. its persistently higher unemployment rate than in other European countries). Chapter 4 describes the recent changes in the Spanish housing market and analyses the associated risks to financial stability. It also looks at the housing affordability problems of recent years and examines possible courses of action to address them.

The *Annual Report* thus supplements the specific analysis of the Spanish financial sector carried out by the Banco de España, presented every six months in the *Financial Stability Report*, the latest edition of which was published in April.

Recent macroeconomic developments

Despite the restrictive stance of monetary policy and the high level of geopolitical uncertainty, in 2023 the world economy grew more than expected. This resilience, which varied across geographical areas, was partly underpinned by strong employment in most economies and, in some regions, fiscal policy support.

Mention should also be made of disinflation, which was mainly driven by the fall in energy commodity prices, the fading of the supply shocks observed in recent years and monetary policy tightening. Against this background, central banks in emerging economies started to ease their restrictive monetary policy stance, while their counterparts in the main advanced economies paused their interest rate hiking cycles.

However, euro area economic activity was observably weak, with the German economy notably sluggish and even contracting slightly. Inflation slowed more than expected and has fallen by 8.2 percentage points (pp) since October 2022 (2.8 pp since March 2023 in the case of core inflation), as the monetary policy of the European Central Bank (ECB) – which set the deposit facility rate at 4% in September – continued to be transmitted forcefully to financing conditions.

Amid monetary tightening, weak euro area growth and high uncertainty, the Spanish economy stood out as it recorded growth (2.5%) significantly above the euro area average (0.4%) and initial expectations. As a result, at end-2023 GDP was around 3% higher than its pre-pandemic level. However, GDP per capita in Spain had only risen by 0.3% since end-2019 (against a background of high immigration flows over the last two years), in contrast to the euro area where it stood 2% above its pre-pandemic level.

GDP growth was mainly driven by buoyancy in household spending (underpinned by strong job creation amid sliding productivity), government consumption and external demand, while business investment proved considerably sluggish. The high growth rates of tourism-related services explained around one-half of growth in 2023.

Meanwhile, the private sector has continued to deleverage, with its debt now down 94 pp of GDP from the peak of 2010. In addition, Spain's current account surplus increased and its negative net international investment position decreased by 7 pp, to 52.8% of GDP, 45 pp below the all-time high recorded in 2014. Meanwhile, the budget deficit and government debt as a percentage of GDP also fell, but they nevertheless remain at high levels.

The disinflation process, which began in 2022 Q3, continued in 2023, driven mainly by lower energy prices, while food and core inflation slowed more gradually. In addition, the slowdown in unit profits cushioned the impact of the growth of compensation per employee.

The outlook for the coming years

Against a backdrop of high geopolitical uncertainty, global economic growth is expected to stabilise at around 3.2% over the coming years, significantly below that observed over the last two decades (3.8%). Some cross-region differences are expected to persist, and inflation around the world will continue to ease.

Turning to the euro area, the ECB staff macroeconomic projections envisage a slow and gradual recovery, to 0.6% in 2024 and around 1.5% in 2025 and 2026, which will be underpinned above all by private consumption, boosted by the increase in real household income resulting from robust wage growth and lower inflation. Government consumption is also projected to continue increasing and external demand is forecast to fare well, against the backdrop of an improvement in the euro area's terms of trade. Financial markets expect the restrictive monetary policy stance to be eased gradually. Nevertheless, the risks to this growth scenario are tilted to the downside, particularly those associated with the war in Ukraine and the conflict in the Middle East.

Inflation is expected to continue to slow over the coming quarters, although in 2024 it will come down more slowly due to upward base effects, the gradual withdrawal of the fiscal measures adopted during the energy crisis and the more persistent services inflation, in line with historical patterns. All things considered, the projections envisage inflation easing to 2.3% in 2024 and to around 2% in 2025 and 2026, which is consistent with the ECB's medium-term target. The risks to these inflation projections are balanced.

Given this situation, we on the Governing Council of the ECB consider that, provided the inflation outlook remains unchanged, it would be appropriate to start to reduce the current level of monetary policy restriction in June. In any event, given the level of uncertainty, we will continue to follow a data-dependent and meeting-by-meeting approach and we are not pre-committing to a particular rate path.

As for the Spanish economy, the [latest Banco de España macroeconomic projections](#) forecast GDP growth falling from 2.5% in 2023 to 1.9% in 2024 and 2025 and to 1.7% in 2026, rates which are above the economy's potential growth.

The main drivers of this projected growth are the European economy's gradual recovery, the fading of the adverse impact of monetary tightening on activity, the recovery in economic agents' real income, forecast population growth and the fiscal impulse from the Next Generation EU (NGEU) programme.

Conversely, markedly weak investment and lacklustre productivity, in addition to the waning of some of the tailwinds that have recently driven growth (related to the sharp correction in some of the adverse supply shocks that weighed on activity in 2021 and 2022), will hold back the future rate of growth.

In any event, a high level of uncertainty surrounds these projections.

First, as in the euro area, the uncertainty stemming from the geopolitical tensions should be noted.

Second, given the persistence of a large structural budget deficit and high government debt, compliance with the new European fiscal rules will require the implementation of a fiscal consolidation plan that gradually corrects these imbalances. Strict compliance with the European rules is key to reducing this vulnerability of the Spanish economy; however, the impact of this consolidation plan would foreseeably result in a lower than expected degree of economic growth. This could be cushioned by designing the plan to foster the economy's potential growth and accompanying it with a package of ambitious structural reforms and the investments – supported by the full implementation of the NGEU programme – needed to improve growth capacity.

Third, unit labour costs have grown significantly despite the contained rise in wage settlements (in line with the recommendations established in the fifth Employment and Collective Bargaining Agreement). This is because compensation per employee in the market economy has in recent quarters grown more than negotiated wage increases under collective agreements. Against a backdrop of higher non-wage costs (for example, social security contributions) and weak productivity, this compensation growth has meant that unit labour costs have risen more in Spain than in other euro area countries since the start of the pandemic, which could ultimately affect the price competitiveness of Spanish firms.

Fourth, the results of the latest waves of the [Banco de España Business Activity Survey](#) show that in recent quarters firms have perceived a rise in economic policy uncertainty. This has become the main constraint on business activity, affecting 58% of firms. Should this continue, it could have a negative bearing on decisions concerning business investment, which has been very weak in recent years, and the future growth path.

Lastly, the projections are particularly influenced by the execution of the NGEU programme, the boost from which is expected to gather pace in 2024 and 2025.

The structural challenges facing the Spanish economy and the role of economic policies

Beyond the short and medium-term outlook, the Spanish economy's growth capacity over the years ahead will be highly influenced by a number of far-reaching structural challenges. These notably include boosting productivity growth, bringing down the high structural unemployment rate, ensuring the sustainability of public finances, reducing the vulnerabilities in certain household segments (in particular in relation to housing affordability), tackling the many challenges posed by the green transition and further strengthening the resilience of Spain's financial system. At the same time, Spain should actively contribute to deepening European integration, which will help us to successfully address the numerous global challenges that we face.

As I have pointed out on other occasions, addressing these challenges calls for the design and implementation of a comprehensive strategy of ambitious and lasting reforms, underpinned by broad consensus. As recently noted by IMF staff in the [Concluding Statement of the 2024 Article IV Mission](#), the absence of such consensus, amid high political fragmentation, could hinder the design and implementation of structural reforms and fiscal consolidation, and could have a detrimental impact on the economic growth outlook. This risk was illustrated when the general State Budget – which plays an instrumental role in defining economic policy for the year – for 2023 was rolled over into this year, thus confirming that the uncertainty indicated by business surveys is real.

1 Driving productivity growth

In recent decades, the Spanish economy has seen a slowdown in productivity growth that has been significantly more pronounced than in other developed countries. Sluggish productivity represents one of Spain's main structural challenges, and is one of the reasons, along with high unemployment rates, why the country has been unable to converge with euro area per capita income in recent decades.

Chapter 2 of this report examines Spain's lacklustre productivity, showing it to be the product of many interacting factors that should be addressed simultaneously. These factors notably

include those shaping firm size and demographics, the reallocation of factors of production across sectors and firms, the level of human capital in the population, the technological capital stock and investment in innovation, and the regulatory and institutional framework.

The establishment of the Productivity Board, whose tasks include conducting economic and statistical analyses of the Spanish economy's productivity and competitiveness, could pave the way for future reforms. If the Board is to be effective, it will need to ensure the independence and expertise of its members, and sufficient resources will have to be available to undertake rigorous analyses.

1.1 Increasing firm size and facilitating cross-sector and cross-firm reallocation of productive resources

Larger firms are typically more productive and more diversified than their smaller competitors, not only in terms of their products and customers, but also their sources of financing. Accordingly, one reason for Spain's low productivity is the high proportion of smaller firms in the economy compared with other European countries. In 2021, 76.8% of Spanish firms had between one and four employees, the highest percentage in the European Union (EU) and far higher than the figures seen, for example, in Germany (63.2%), France (70.4%) and Italy (72.5%). This gap has been relatively stable over recent decades and cannot be wholly attributed to the specific sectoral composition of the Spanish economy.

In terms of business demographics, the low productivity growth among active firms and the small contribution of net firm entry stand out. Similarly, firm entry and exit rates (a mechanism that is typically one of the main contributors to productivity gains), have declined, particularly in the most recent period.

Many obstacles shaping firm size and demographics in Spain have been identified. These notably include those related to the quantity and complexity of regulations (which sometimes also create obstacles to market unity), certain regulatory thresholds arbitrarily linked to firm size, low access to non-bank financing, inefficient insolvency proceedings and public tender procedures that tend to result in contracts being awarded to large firms. Removing these obstacles could significantly boost productivity growth.

As described in Chapter 2, various initiatives have been approved in recent years in an attempt to bolster business growth and smooth the efficient reallocation of factors of production.

However, it is still too early to accurately assess whether these initiatives will be able to correct the weaknesses identified.

1.2 Fostering the accumulation of human capital

The level and quality of human capital are key determinants of economic growth. At individual level, there is a clear positive return to education, one that seems to be increasing over time. For instance, in 2019 an upper secondary education or intermediate vocational training provided a return – in terms of future labour income – of 18% for men and 26% for women compared with compulsory secondary education alone.

Despite improving in recent decades, the population's educational attainment level remains below the European average. Spain continues to have one of the highest early school leaving rates among European countries, its results in international educational assessments (such as the OECD's PISA) are relatively mediocre and the educational attainment level among adults (employees, employers and the self-employed alike) is low.

Public policies should encourage students to remain in school and improve their performance at lower levels of education. Indeed, various tutoring programmes are already available and have proven helpful. Furthermore, the public sector should provide students (and their families) with sufficient information on the employment returns to education to help them to make informed decisions. Enhancing the Spanish population's financial literacy, which remains low, would also further this objective.

The educational system must also be readier to adapt to the structural shifts in the labour market. Conventional (i.e. on-site) public university education seems to be responding only very slightly to changes in demand, which could hold back the economy's productive capacity and constrain equality of opportunity.

Meanwhile, high-quality vocational training could be a very effective means of reducing both the early school leaving rate and some of the existing supply and demand mismatches in the labour market, which could increase in the future. The dual vocational training system has proven effective in improving employability, wages and job retention rates. If the targets set in the Recovery, Transformation and Resilience Plan for increasing the number of training positions are to be met, firms must be provided with the right incentives to generate these positions. However, at international level, there is no clear evidence that the better short-term returns to the dual model continue over the working life, particularly

in a context of rapid technological change. Therefore, the continuing professional development system should be reinforced at the same time as the dual vocational training system is rolled out.

1.3 Promoting investment in physical and technological capital and innovation

The low share of innovation in Spain's economy has also contributed to the country's lacklustre productivity. Spain has a lower percentage of innovative firms than other European countries, even when the firms' smaller size and sectoral distribution are taken into account.

Since the outbreak of the health crisis, the recovery in investment in intangible assets in Spain has been stronger than in the other investment components. However, it has not grown enough to significantly close the gap with average euro area levels. In 2023, investment in machinery and equipment in Spain was more than 8 pp below its pre-pandemic level, whereas in the euro area it stood 3% above the pre-pandemic figure.

In order to promote business investment and innovation, efforts are required to smooth access to external financing, develop venture capital markets and review the efficiency and design of tax incentives for innovation. The recent measures rolled out in this area, such as the Law on Developing the Ecosystem of Emerging Businesses and the Law on Science, Technology and Innovation, could further these objectives. A stable regulatory framework and institutional environment must also be provided.

1.4 Improving institutional quality and trust

The institutional framework, its quality and, in particular, the degree of trust that institutions instil among economic agents are key in determining long-run growth. According to various indicators, institutional quality and trust in Spain have deteriorated since the financial crisis, more so than in other European countries.

Action is therefore needed to boost the efficacy and efficiency of Spanish public administrations, including the judicial system. The future approval of the statute of the Public Policy Assessment Agency should pave the way for ex ante and ex post assessments of central government policies and programmes (any ex post public spending reviews will be performed by the Independent Authority for Fiscal Responsibility (AIReF)). Furthermore, public policy assessments would ideally be extended to all tiers of government.

2 Reducing the high structural unemployment rate

Between 2019 Q4 and 2023 Q4, 1.28 million jobs were created in Spain. The employment rate (the number of employed persons relative to the population aged 16 to 64) increased from 63.7% to 65.9% in that same period. Meanwhile, the temporary employment ratio decreased to 16.5% (from 25.4% at end-2021), thus converging significantly towards the euro area average, although it remains close to 30% in the public sector. However, outflows from employment into unemployment (which proxy job stability) are still significantly higher than those observed for the euro area as a whole.

Employment has grown with considerable heterogeneity across sectors, occupations and regions, with the largest increases concentrated in the public sector, among people with a higher educational attainment and in the regions with the lowest employment rates. Foreign nationals accounted for 72% of the labour force increase between the start of 2022 and end-2023 (788,000 people) and 54% of the 1.06 million new persons employed in this period.

As a result, the unemployment rate has trended downwards since mid-2020. However, at end-2023 it was still 11.8%, twice that of the EU27. This difference is especially marked in terms of youth unemployment, the incidence of long-term unemployment and the employment status of workers approaching the retirement age. And, despite this high unemployment rate, labour shortages can be seen in certain sectors.

A considerable portion of the cross-country differences in unemployment rates are related to labour market institutions and policies. These typically include the design of active labour market policies (which should mainly aim to make the unemployed more employable) and passive labour market policies (which should offer an appropriate level of protection for the unemployed while providing sufficient incentives for them to return to work), and other factors that influence both the rate of job creation and job stability (e.g. the different types of contracts available, the level of termination costs and many factors with a bearing on collective bargaining).

The labour market is undergoing profound changes, from both a technological and demographic standpoint. The technological changes stem mainly from advances in robotics and artificial intelligence. The demographic shifts are above all related to the ageing workforce, resulting from lower numbers of new entrants in the labour market and a longer working life. Both factors have important implications for labour supply and demand and for the effectiveness of labour market and, more generally, economic policies.

Given this situation, reviewing labour market policies is a priority. Specifically, in line with the new Employment Law, the public employment services should introduce new techniques for job profiling and for matching job-seekers to the available vacancies. Training and job intermediation programmes should be assessed continuously to improve both their design and the allocation of resources, and to evaluate possible partnerships and synergies with the private sector. Meanwhile, unemployment benefits should afford the unemployed appropriate protection, but without disincentivising job-seeking and labour mobility. This could be achieved, for example, by allowing certain benefits to be compatible with employment and by reducing their amount over time.

In addition, to foster the necessary sectoral and occupational reallocation of employment, more headway should be made in defining the objective grounds for dismissal and in making such processes less uncertain. To the same end, collective bargaining should allow for a degree of flexibility to enable employment conditions to cater to firms' individual circumstances.

Longer working lives should be encouraged not just by increasing the statutory retirement age, but also by doing away with certain aspects that, in practice, serve to drive older workers out of the labour market.

The national minimum wage has risen by 54% since 2018 and now exceeds 60% of the gross median wage, with wide disparity across provinces. It is estimated that 12.7% of workers will earn the national minimum wage in 2024. At these levels, it would be advisable for potential future increases in the national minimum wage to take into account (through a detailed ex ante analysis) the possible adverse effects that, in the absence of productivity gains, such increases could have on employment for certain groups of workers, firms and regions.

Finally, moving forward with the reduction of the statutory working week without taking into account either the considerable differences in working hours across firms and sectors or productivity gains – which are ultimately what make wage increases and shorter working hours possible – would pose risks to employment growth.

3 Ensuring the sustainability of public finances

Although the public debt-to-GDP ratio has declined from its pandemic peak of 120.3% in 2020 to slightly below 108% at end-2023, this level is historically very high and around 30 pp above the euro area arithmetic mean (17 pp higher than the euro area weighted average).

The general government deficit declined from 4.7% of GDP in 2022 to 3.6% in 2023. In a setting in which public spending remained high, this reduction was attributable to the continuing strong growth in revenue. Since 2019, tax and social contribution receipts as a share of GDP increased by 2.5 pp, reaching a level slightly above the EU arithmetic mean (although 3 pp below the weighted average).

Strong government revenue growth over the last four years has been predominantly driven by personal income tax, due to real growth in both the number of taxpayers (employed persons and pensioners) and the nominal tax base (wages, social benefits and other household income), which is being boosted by the inflationary episode. Indeed, nominal growth in the personal income tax base may trigger an increase in the effective average tax rate when the parameters determining the tax liability are not fully updated in line with growth in the taxable base. This effect, known as “fiscal drag”, means that a given percentage increase in income results in tax payable rising by an even higher percentage. Overall, effective average personal income tax rates are estimated to have risen from 12.8% in 2019 to 14.7% in 2023, with 70% of this increase attributable to fiscal drag. The impact appears to have been most pronounced for taxpayers in the middle of the income distribution.

The increase in revenue, however, has been more than offset by the rise in expenditure. As a result, according to Banco de España estimates, the Spanish general government structural deficit increased from 3.1% of GDP in 2019 to 3.7% of GDP in 2023.

3.1 Designing and implementing a medium-term fiscal consolidation plan

Correcting the large imbalance in public finances requires the prompt implementation of a medium-term fiscal consolidation plan.

The consolidation plan will need to be aligned with the new EU fiscal framework. Under this framework, each Member State will prepare budgetary plans, which may span up to seven years under certain conditions (carrying out structural reforms that improve growth potential or making public investments aligned with the EU’s common priorities). According to Banco de España estimates, compliance with the new fiscal framework would require an average annual reduction in Spain’s primary structural deficit of around 0.5 pp of GDP between 2025 and 2031.

The plan should also be grounded on prudent macroeconomic projections and specify the revenue and expenditure measures that will allow the deficit targets to be achieved. This would increase confidence in the consolidation process and certainty about economic policies.

As for the elements of the plan, it is essential to increase efficiency on the public expenditure side, in line with the recommendations of the AIReF's Spending Review, and to optimise the distribution of expenditure across the different items in order to promote robust and equitable economic growth. On the revenue side, a comprehensive review of the tax system should be carried out to improve its effectiveness and efficiency. The reform should increase the relative share of consumption and environmental taxation (which is low compared to that of other European economies), reduce the substantial tax benefits and improve international tax coordination.

The consolidation plan will also require the involvement of all tiers of general government. Furthermore, a reform of the regional government financing system is still pending to correct some of the shortcomings it has displayed over the past decades. This reform should ensure that the Spanish regions have sufficient resources available for their actual spending needs (based on objective calculations), and that there is fiscal co-responsibility and transparency in the various parameters that determine the functioning and development of the system. Strict implementation of fiscal rules at all levels of government is also crucial. In this regard, a possible cancellation of some of the debt accumulated by Spanish regions in recent decades could reduce the incentives for them to maintain fiscal discipline in the future. The reform should also address the system's lack of stability, which has created an incentive to pursue negotiations as a means of securing more funding.

3.2 Ensuring the sustainability of the pension system

The Spanish economy is undergoing a process of population ageing that will intensify over the coming decades and will be more pronounced than in other European countries. Drawing on Eurostat projections, between 2023 and 2053 the dependency ratio (the ratio of the population aged over 66 to those aged 16-66) in Spain will rise by 27.2 pp to 53.8%, compared with an average increase of 16.6 pp, to 45.8%, in the EU.

Meanwhile, although migration flows have surged in recent years, it seems unlikely that this will offset population ageing, or effectively smooth any mismatches that might arise in the labour market.

From the standpoint of public finances, this demographic growth will lead to a substantial increase in pension expenditure over the coming decades. According to AIReF projections, under a baseline scenario pension expenditure will climb from 13.6% of GDP in 2021 to 16.2% in 2050, while the European Commission's [2024 Ageing Report](#) sets pension expenditure in that year at 17.3% of GDP under its baseline scenario.

In this setting, between 2021 and 2023 a new pension system reform was implemented that included, among other measures, CPI-based pension revaluation enshrined in law, elimination of the sustainability factor, greater incentives to delay the retirement age and increased social security resources from higher contributions from both employers and workers. Moreover, in the event of future financial imbalances in the pension system, increasing contributions becomes the adjustment process by default (the backstop mechanism).

An overall analysis of the main regulatory changes made – albeit subject to considerable uncertainty – points to higher expenditure obligations in the long term that are not fully offset on the revenue side. The backstop mechanism introduced in the new reform will be reviewed in 2025. Our estimates suggest that, should it be necessary to activate the backstop, making the necessary adjustment purely by raising social security contributions could be detrimental to employment and to the competitiveness of the Spanish economy.

Looking ahead, an in-depth analysis of the different regulatory changes made would be desirable. Regarding the incentives to postpone the retirement age, this report includes an analysis which suggests, as a first approximation, that there would be no major reduction in pension expenditure as a result. It would also be important to analyse: first, the effects of the increase in social security contributions on the labour market and the competitiveness of Spanish firms, and the consequences for intergenerational equity; second, alternative measures, including those affecting replacement rates which are high by international standards; and third, developments in private retirement saving and its ability to complement public pensions.

4 Reducing vulnerabilities observed in some household segments

Data from the Spanish Living Conditions Survey suggest that, against a backdrop of strong employment growth, in 2022 income inequality in Spain was very similar to, and even lower than, that observed before the start of the global financial crisis.

However, there are pockets of vulnerability among certain groups, largely related to difficulties finding employment and housing. Indeed, Spain is the European economy with the highest percentage of people living in rented housing at risk of poverty or social exclusion, specifically 45% in 2022, compared with an average of 31% in the EU27.

In 2020, according to data from the [Banco de España's Spanish Survey of Household Finances](#), 54.3% of the economy's total net wealth held by Spanish households was concentrated among

the wealthiest 10% of the population, compared with 43% in 2002. This is, however, a substantially lower percentage than that observed in other countries. On a global scale, in 2021, for example, the wealthiest 10% of the population held 76% of total wealth.

In addition, the correlation between parents' level of educational attainment and that of their adult offspring decreased in the second half of the 20th century, suggesting greater intergenerational mobility and, therefore, more equality of opportunity. Nevertheless, the level of this correlation varies significantly across municipalities and provinces.

Addressing the challenges posed by these pockets of vulnerability among Spanish households requires public policy actions across a broad range of spheres. In particular, it is vital that the high structural unemployment rate be reduced and that human capital be strengthened through improvements in the quality of the Spanish education system.

Moreover, income and transfer policies can play an important role in mitigating the adverse effects associated with high levels of inequality or vulnerability, although their capacity to attain the proposed goals must be analysed, along with their implications in terms of efficiency and equity. In this respect, some AIReF studies suggest that there is scope for improved integration of the minimum income scheme, the various local and regional subsistence income schemes and unemployment assistance benefits.

4.1 Alleviating housing affordability problems

In recent years there has been a growing supply and demand mismatch in the residential housing market – in the house purchase and the rental segment – owing to both demand strength and relative supply rigidity.

Demand has been driven by demographic growth, largely associated with significant external migration flows which have intensified since 2022 and are concentrated in certain regions and in the main urban areas. It has also risen as a result of strong demand from non-residents, both for home ownership and rentals (mainly in the holiday segment). And all this in a favourable macroeconomic environment in which, despite the monetary tightening that began in 2021, house purchases and new mortgage credit flows in 2023 were above their 2019 levels.

By contrast, growth in the residential housing supply has been more lacklustre. New housing in particular has made a limited contribution to the aggregate residential housing supply, among

other factors owing to construction workforce shortages, rising production costs and the lack of investment in acquiring and developing new urban land available for construction. The relative supply rigidity is also explained by the low capacity for housing renovation, the mismatch between empty housing and current household preferences, regulatory uncertainty and the rise in alternative housing uses, such as holiday or seasonal rentals.

As a result of these residential housing supply and demand mismatches, prices have risen continuously since 2014, especially in the large urban and tourist areas which are those that have experienced most increase in demand.

The supply and demand mismatches are particularly acute in the residential rental segment in the city centres. Housing demand among lower-income groups, such as young people and the foreign-born population, is concentrated in the rental market. This is partly because these groups do not have sufficient savings or income to be able to obtain a mortgage.

Although the proportion of individual landlords in the residential rental supply has increased significantly, the market has not grown sufficiently to absorb the surge in demand, in a setting in which professional agents and social rentals account for only a small market share. The supply shortage and the problems in the way the rental market works are reflected, for instance, in the fact that rental prices are high compared with house prices, especially in areas where there is a high concentration of lower-income households.

From the financial stability standpoint, the associated vulnerabilities and risks are contained. This is largely due to the prudent mortgage lending credit standards applied by banks, which have prevented the build-up of imbalances such as those that led to the 2008-2013 real estate and banking crisis. In this respect, there are no warning signs in relation to the credit market and no signs of real estate activity becoming oversized. Moreover, according to the latest data, housing valuation indicators appear, on average, to be close to equilibrium.

By contrast, housing affordability difficulties have increased in recent years. These problems are greater for lower-income households and those with scant saving capacity, groups that include a high proportion of young people and foreign-born population. By geographical area, the difficulties are most acute in areas that are more economically buoyant and those with higher levels of tourism.

However, the proportion of home-owner households with a mortgage that are overburdened by their housing costs is low. This appears to reflect, at least in part, sound selective lending

by banks, which only extend credit to households that have sufficient savings and income relative to the price of the property concerned. By contrast, the percentage of renter households that are overburdened by their housing costs is very high, above the EU27 average.

Housing affordability problems have adverse social and economic effects. In particular, if households are overburdened by their housing costs their ability to save is limited and this may distort their consumption and investment decisions, among others, and also their decisions on where to live, whether to have children and whether to continue their education. In consequence, housing affordability difficulties may give rise to lower aggregate productivity and lower economic growth.

Considering the scale of the problem, it seems unlikely that isolated short-term actions may be sufficient to significantly reduce today's housing affordability difficulties. At the same time, measures such as rent controls, which may have relatively limited effectiveness in the short term, could ultimately have significant unwanted effects, for instance by reducing the housing supply.

Instead, the reforms adopted should ideally extend over a long time horizon and involve the different tiers of government with responsibility for housing, in a coordinated manner and in collaboration with private initiative. These measures should focus on stimulating the housing supply – especially rental and social rental housing – and on prioritising allocation of the available resources to the most vulnerable groups. In addition, other areas that affect the housing market, such as the functioning of the labour market, productivity growth and tax and transport policies, should also be considered.

5 Tackling the green transition

The fight against climate change and the transition towards a more sustainable economy are among the key challenges facing society. Spain has taken on ambitious environmental commitments, in line with those established in the EU and in other advanced economies.

The Banco de España has developed an intense research agenda that seeks to delve into the diverse implications of this issue for the Spanish economy. Indeed, a specific [chapter](#) of our *Annual Report 2021* was dedicated to environmental matters, which was complemented by an [analysis](#) of the implications of the energy crisis in the *Annual Report 2022*.

These analyses confirm the high economic costs of staying on the current path of global greenhouse gas emissions. They also underline the fact that delaying action will drive up both the physical and transition costs involved. This calls for adopting a mitigation strategy that is ambitious, timely, orderly and predictable. And if it is to be effective, this strategy needs to be global. Governments must play a leading role in this process, through environmental taxation, public investment and regulation of economic activity. Specifically, it will require the large-scale deployment of renewable energy sources, for which Spain has a very favourable climate. It will also call for making a determined commitment to improving energy efficiency which, in turn, will help ease the green transition's adverse impact on activity.

It should also be borne in mind that climate change and the transition to a more sustainable economy will have a highly heterogeneous impact across regions, sectors, firms and households and may hit the most vulnerable particularly hard. Consequently, particular care must be taken to temper distributional effects. Otherwise, not only would the green transition be more costly in economic terms, but the pace and ambition of the process could also be constrained by episodes of social unrest.

6 Continuing to strengthen the Spanish banking sector's resilience

The banking sector in both Spain and the EU as a whole has proven resilient over the past year. Banks' financial position has benefited from their adaptation to the macro-financial environment of monetary tightening that has brought an end to the prolonged period of low interest rates in which they had operated for close to a decade. One contributing factor in this respect, in addition to strong economic growth, has been their robust financial position in the face of the interest rate hiking cycle, facilitated by the international regulatory framework developed over the last few years, which has proved itself effective.

Specifically, Spanish banks have managed to significantly improve their profitability, thanks mainly to growth in their net interest income, and also to their contained impairment losses, especially in their business in Spain.

The sound performance of net interest income has, in turn, been underpinned by the asymmetric pass-through of the interest rate rises to bank credit and deposits. Although there has been a slight contraction in credit, in line with its higher cost following the monetary policy tightening, this has not been sufficient to weigh on banks' earnings.

Moreover, the banking system's liquidity position has held at levels well above minimum requirements. As regards solvency, despite the slight improvement, the unfavourable gap with respect to the average of the main European banking systems has not narrowed.

But banks' sound performance should not be cause for complacency, especially given the still high level of uncertainty.

First, it is important to recognise that the improvement in net interest income associated with the interest rates hikes has likely already peaked. Consequently, net interest income could level off or even decline, if the bank lending-deposit spread were to gradually narrow. Second, there may be a lag before the bulk of the adverse effects of the recent monetary tightening, such as the deterioration in credit portfolio quality, materialise.

Banks should therefore take advantage of their favourable profitability situation to improve the sector's solvency. This would help preserve their bank intermediation capacity, should the aforementioned risks materialise.

In this setting, the Banco de España is analysing the possibility of setting a positive rate for the countercyclical capital buffer (CCyB) in those instances when cyclical systemic risks are at a standard level (i.e. between a high and low level). Early activation of the CCyB would provide more capital that can be released in adverse phases of the cycle, which would help sustain the flow of credit to the real economy during downturns and contribute to the objective of macroeconomic stabilisation. The Banco de España will announce its conclusions on this matter around when this *Annual Report* is published.

In tandem, banks should continue to address the many medium and long-term challenges they face, not least those associated with technological change, interconnections with the non-bank financial sector, financial risks from climate change and cyber risks.

7 Strengthening European integration

The national agenda of economic reforms needed in Spain will have a greater impact if it is accompanied by deeper economic integration at European level, enabling the EU as a whole to tackle our shared challenges.

The world today is more complex and integrated than when the European single market or even the Economic and Monetary Union (EMU) was created, and economic and geopolitical

competition between the different global players has become stronger. This calls for further integration in the EU, so that it can reap the maximum benefit from its potential scale, and the way to achieve this is a more integrated single market and a more complete union.

7.1 Advancing towards a fiscal union and ensuring budgetary stability

The challenges currently facing the EU are common to all the Member States and, as such, call for joint action. National solutions are not enough. This is particularly true in areas such as defence and security, energy infrastructure and the fight against climate change, and support for certain global providers of strategic technological capabilities.

As these are European public assets, such needs should be funded through common policies and resources. Funding them at the national level would be inefficient, as it would not properly internalise the needs and priorities of the EU as a whole. It would also be insufficient and distortionary, as it would depend on each country's individual fiscal space or on the introduction of differential incentives in the form of State aid that could distort competition within the European common market.

Beyond guaranteeing an optimum stock and efficient supply of these European public assets, it will also be necessary for the euro area to have cyclical mechanisms that ensure an appropriate aggregate fiscal policy stance at all times. Past experience has shown that, on their own, mechanisms for coordinating the fiscal policies of individual Member States, such as the Stability and Growth Pact (SGP), have failed to achieve this goal.

All this without forgetting that budgetary stability is essential to the functioning of the EMU. Following the approval of the SGP reform, the success and credibility of the new framework will hinge on its effective application by all Member States.

7.2 Completing the banking union and creating a capital markets union

The economic and geopolitical challenges facing the EU also call for sizeable private investments, particularly in the areas of digital transformation, the green transition and technological innovation. To this end, the EU's capital markets must be expanded and become more integrated. Meeting both of these goals would ensure that the substantial domestic saving in Europe could be efficiently channelled towards profitable investment projects that are conducive

to growth. Specifically, the capital markets have shown that they can offer financial products that are more tailored to high risk-return research and innovation activities than bank financing, which is, however, more predominant in Europe than in other more dynamic economies such as the United States.

In order to increase the depth of the capital markets, private pension schemes in the EU must be properly promoted and channelled towards productive investment, which would also help address some of the challenges associated with population ageing. In this respect, households' pension savings assets are far higher in the United States (137% of GDP in 2022) than in the EU (less than 30% of GDP), demonstrating the difference in scale of the US capital markets vis-à-vis their European counterparts. There is also a high degree of heterogeneity across EU Member States.

The EU's capital markets are not only shallow, but also fragmented, which prevents achieving an efficient scale and appropriate risk-sharing within the private sector across EU countries. The literature estimates that the degree of risk-sharing in the United States is double that in the EU. Moreover, the private capital markets play a key role in smoothing shocks in the United States, in contrast to their very small role in Europe.

Reducing fragmentation in these markets calls for a wide range of initiatives and, in any case, reinforcing European regulatory and supervisory measures to accelerate integration. The existence of a pan-European safe asset with sufficient market depth could contribute to capital market integration, insofar as it would enable a more accurate reflection of the fundamental risks of debt securities or equities in their prices. This would ease the flight-to-quality episodes that characterise fragmentation processes during periods of financial stress, which ultimately distort price formation and can even impede the proper transmission of monetary policy.

As regards the banking union, significant advances have been made over the past ten years, with the creation of the Single Supervisory Mechanism, the Single Resolution Mechanism and a single regulatory framework. However, work remains to be done, as the creation of a fully mutualised European Deposit Insurance Scheme (EDIS) is still pending. The lack of such a pillar means that Europeans do not enjoy the benefits of greater financial stability and a stronger common financial safety net. In addition to boosting public and market trust in the banking union, implementing the EDIS would contribute to more efficient risk-sharing in the euro area and would, therefore, help to reduce potential fragmentation episodes. Also, from a political-institutional standpoint, it would help to align financial responsibility with the supervision and resolution decision-making mechanisms, which are already centralised.

7.3 *Pressing ahead with a dynamic and competitive common market*

Beyond further integration of Europe's financial markets through the banking union and the capital markets union, the main driver of economic integration and economies of scale in the EU is the European common market. In view of the risks of global economic fragmentation, the EU needs to reduce any internal fragmentation.

The single market should also serve to maximise the impact of an ambitious pan-European agenda of liberalisation and structural reforms, to counter the succession of adverse supply-side shocks that have affected Europe's economy in recent years, such as the pandemic, the energy crisis and the shifts in globalisation patterns.

As highlighted in the Letta report on the future of the European single market,¹ moving to a deeper single market entails giving greater emphasis to the role of European policies, to the detriment of national ones. Moreover, European initiatives that seek to develop specific strategic sectors should be designed so as to maximise their effectiveness and efficiency and avoid distortionary effects.

In short, the EU and Spanish economies both face very significant challenges. In terms of economic dynamism, Europe is lagging behind the other major world economies, and for more than a decade now Spain has been unable to maintain a sustained per capita income convergence path with our European partners. Reversing these trends will take ambition and major political agreements, to ensure that the reforms needed can be consolidated over time. The analysis and proposals set out in the *Annual Report 2023* seek to contribute to the social debate that should help achieve such broad consensus.

Pablo Hernández de Cos

Governor of the Banco de España

Foreword to the Annual Report 2023.

30 April 2024.

¹ Enrico Letta. (2024). "Much more than a market".