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RISKS LINKED TO THE MACRO-FINANCIAL ENVIRONMENT

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Despite the geopolitical tensions and tight monetary policy stance, the global growth outlook for 2024 has been revised upwards somewhat since last autumn, owing mainly to the impact of certain positive surprises in the United States. In any event, a moderate slowdown compared with last year is expected. In addition, some regions, the euro area in particular, have shown greater weakness and their outlook has deteriorated.

The main pockets of uncertainty relate to the course of geopolitical tensions, the correction in China's real estate market and the country's general economic performance, and developments in US financial conditions amid a still robust labour market. In emerging markets, the main risks to financial stability stem from the external environment, with persisting vulnerabilities in some of the economies to which the Spanish banking system is significantly exposed.

The Spanish economy showed robust growth in 2023, which prompted an upward revision to the outlook for 2024, although a gradual slowdown is expected. In any event, the projections continue to be surrounded by high levels of uncertainty, with downside risks to activity related to global economic developments and the aforementioned geopolitical tensions.

Over the last six months, financial market expectations of changes in the direction of monetary policy in the advanced economies have led to a drop in short-term and long-term interest rates, helping to drive up financial asset prices. Risk premia have also decreased in some asset classes and, broadly speaking, are holding at historically low levels. In any event, interest rate expectations have been revised upwards since the beginning of the year, especially in the United States, where the markets expect somewhat smaller policy rate cuts than anticipated six months ago.

Prices in the Spanish residential real estate market slowed somewhat towards the end of last year, but demand-side pressures persist due to a higher number of households, the entry of foreign buyers and a recovery in tourism. Commercial real estate prices have remained stable, except in prime areas where prices have fallen.

Both households and non-financial corporations (NFCs) have continued to bear rising interest expenses, but resilient employment and the improvement in incomes and profits continue to mitigate the materialisation of financial risks. Marked deleveraging continues in both segments.

The economy's nominal growth has also helped reduce the budget deficit and external imbalances. However, government indebtedness remains high, as does the structural budget deficit, which constitutes a source of vulnerability amid mounting pressures on government spending, not only as a result of the higher interest rate environment, but also due to structural phenomena such as population ageing, climate change and higher defence spending prompted by geopolitical tensions.

1.1 Macroeconomic environment

1.1.1 Systemic and material countries

Global economic activity grew more robustly than expected in the final stretch of 2023 and early 2024. In this period, the positive surprises were concentrated in the United States, China and some emerging economies (see Chart 1.1.a). This improvement in activity is largely attributable to the gradual unwinding of global production chain bottlenecks and falling energy commodity prices. These developments, together with strong employment, a recovery in household purchasing power, continued fiscal support measures and, in some cases, use of the savings buffer built up during the pandemic, explain the robust private consumption seen globally. The growth outlook for 2024 has been revised upwards somewhat in recent months, but still points to a moderate slowdown compared with last year.

In the euro area, recent developments in activity indicators suggest that the weakness observed in 2023 H2 persists. During that period, activity was weighed down by the lagged effects of high energy prices and the tightening of financial conditions, which affected the manufacturing sector in particular. The economic outlook for the euro area points to a slow and gradual recovery, driven by a progressive improvement in agents' confidence and in real disposable income. All told, growth will foreseeably remain very subdued in both the short and medium term.

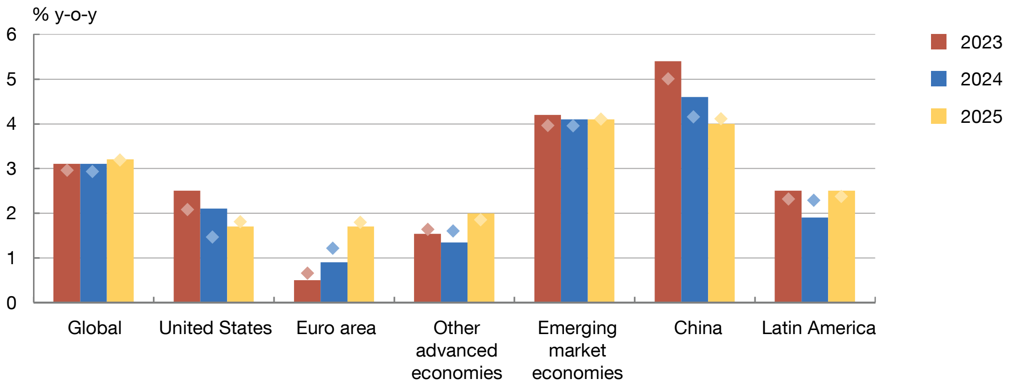
Global inflation has been on a declining path in the recent period. The fall in headline inflation rates, against a backdrop of tight monetary policy, has been accentuated by falling energy prices in recent months, while underlying inflation, which has proven more persistent, shows clear signs of containment (see Chart 1.1.b). Inflation expectations remain anchored thanks to the absence of significant second-round effects. Looking ahead, the recent trends are expected to continue over the coming quarters. However, the ongoing disinflation process is not without risks, in particular those related to a potential deterioration in the geopolitical situation that might prompt commodity price spikes or the re-emergence of bottlenecks.

The risks to global economic activity now appear more balanced, but factors tilting them to the downside persist. These risks again include those stemming from geopolitical tensions, which have heightened in recent months due to the conflict in the Middle East and the attacks in the Red Sea, whose duration and scope remain uncertain. The materialisation of these risks could lead to higher commodity prices and transport costs, more bottlenecks and greater trade and financial fragmentation, which would adversely affect global activity and inflation. Several important elections are also set to take place in 2024, adding an extra layer of difficulty in predicting the course of this geopolitical context. Box 1.1 analyses more closely developments in the uncertainty indicators and their potential economic impact.

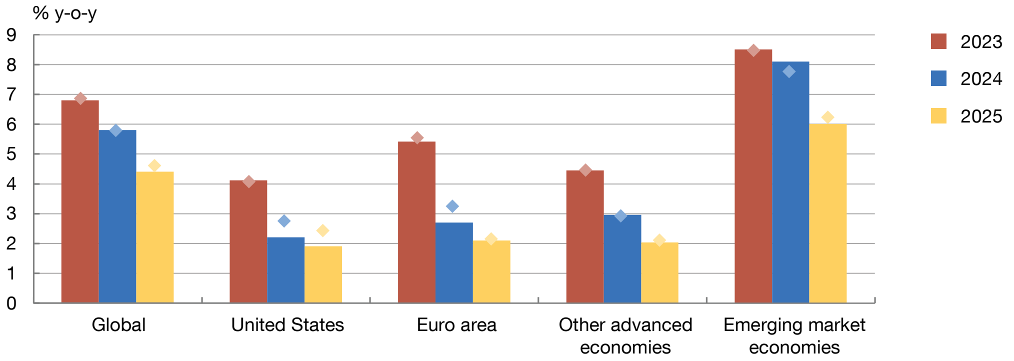
The risks associated with the sharp contraction in the Chinese real estate market remain significant. A case in point is the liquidation in late January of the property development company Evergrande, although no significant spillover to other property developers has been

Chart 1.1
Forecasts for the global economy envisage growth stabilising against a backdrop of global disinflation

1.1.a GDP growth forecasts (a)



1.1.b Inflation forecasts (a)



SOURCE: IMF.

a The bars denote the latest forecasts (IMF World Economic Outlook Update, January 2024). The diamonds denote the previous projections (IMF World Economic Outlook, October 2023).

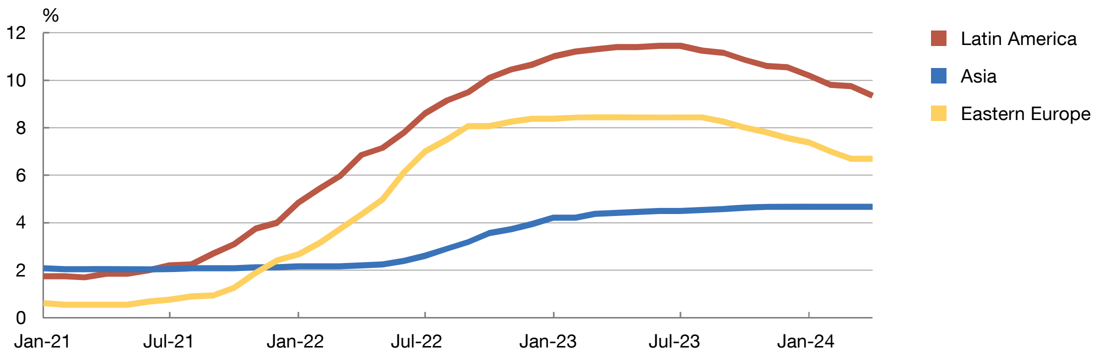
recorded for the time being. An abrupt slowdown in China would pose a downside risk to growth in the main world economies – which would be affected via the trade channel and through heightened uncertainty, with potential effects on global financial markets – but also a downside risk to inflation due to lower demand for commodities and industrial goods.[1] Several agencies have lowered their ratings outlook, underscoring the current concerns over developments in the Chinese economy.

Global financial conditions could also be tightened owing to rising long-term interest rates. In particular, this could stem from the deteriorating fiscal outlook in some systemic economies, such as the United States, or increased risk in the commercial real estate sectors of some advanced economies.

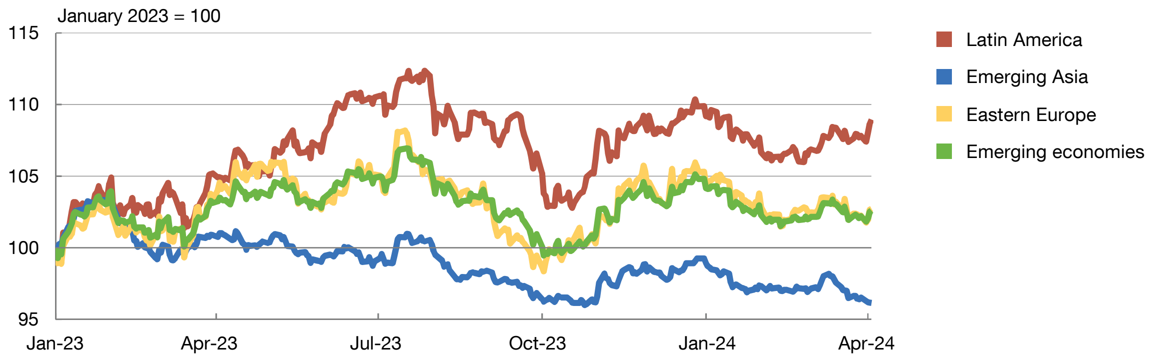
1 Irma Alonso, Daniel Santabárbara and Marta Suárez-Varela. (2023). "The potential global effects and transmission channels of a slowdown in Chinese growth". *Economic Bulletin* - Banco de España, 2023/Q4, 06.

Chart 1.2
The start of the monetary easing cycle in some emerging market economies has not, as yet, prompted a marked depreciation of their currencies

1.2.a Policy rates in emerging market economies (a)



1.2.b Exchange rates against the dollar (a) (b)



SOURCES: Refinitiv and national statistics.

a “Latin America” is the average of Brazil, Mexico, Chile, Colombia and Peru. “Emerging Asia” is the average of India, Indonesia, South Korea, Thailand, the Philippines and Malaysia. “Eastern Europe” is the average of the Czech Republic, Hungary, Poland and Romania (in Chart 1.2.a) and also Bulgaria (in Chart 1.2.b). The “Emerging economies” aggregate is the average of the regions shown.
b An increase denotes appreciation against the dollar. Average of the three regions shown.

Broadly speaking, emerging economies have proven more resilient than expected. Inflation has eased towards rates more in line with central banks’ targets, allowing the monetary easing cycle to get under way in most emerging countries (see Chart 1.2.a). This pattern is expected to continue over the coming quarters and to spread to other central banks, with notable exceptions such as Türkiye and Argentina, which still face significant inflationary pressures.

Emerging financial markets also performed relatively well over the last six months. In general terms, Latin American markets again outperformed those of other emerging regions (see Chart 1.2.b), thanks to the higher profitability of carry trades[2] and their greater distance from today’s global geopolitical conflicts.

2 Where an investor borrows in a currency with lower interest rates and invests in a financial asset denominated in a higher-interest currency, in this case a Latin American one. This strategy entails exchange rate risk, among others.

The main risks to financial stability in emerging economies stem from the external environment. For instance, tighter than expected monetary policy in the United States could lead to capital outflows, exchange rate depreciation and higher risk premia. Similarly, lower than expected growth in China would reduce its external demand, which would lead to lower commodity prices for commodity-exporting economies.

On the domestic front, the main risks for these economies relate to more persistent inflation and fiscal vulnerabilities in some countries. Some of the countries still face idiosyncratic risks arising from domestic political tensions and economic policy uncertainty, with multiple elections set to take place in 2024. Below is a brief overview of the main vulnerabilities of the three emerging market economies to which the Spanish banking system is most exposed.

In Mexico, underlying inflation remains high. The economy showed signs of a slowdown in 2023 Q4, but the output gap is expected to remain in clearly positive territory.[3] This appears consistent with the Mexican central bank's cautious approach to starting the monetary easing process, doing so later (with its first policy rate cut, of 25 basis points (bp), coming at its March meeting) than other inflation-targeting central banks in the region. Meanwhile, bank lending has continued to accelerate, in particular consumer lending, although the country's banks maintain adequate levels of capital and liquidity.

In Brazil, activity slowed markedly in the second half of the year as a result of weak investment. Inflation is holding above the Brazilian central bank's target, but some price containment factors were observed in certain services (education and health) and energy. The central bank has continued to cut its policy rate, although monetary policy remains in restrictive territory, contributing to a slowdown in bank lending. The country's public debt is very high, standing just below 90% of GDP in 2023 according to International Monetary Fund (IMF) estimates. Reducing this debt would require strict adherence to the new fiscal rules that were recently approved.[4]

In Türkiye, there have been some signs of stabilisation since mid-2023. The Central Bank of the Republic of Türkiye has raised policy rates on nine consecutive occasions, for a cumulative increase of 41.5 percentage points (pp). The most recent increase came in March, when the rate was lifted from 45% to 50%, above previous market expectations. It has also widened the interest corridor and indicated that it would raise rates further if necessary. The outlook for inflation has been declining, although in that same month the year-on-year rate climbed to 68.5%. Moreover, the central bank is providing for a steady and gradual adjustment in the lira exchange rate, while it has made progress towards regulatory simplification and introduced measures to control credit growth. For its part, the Government has raised taxes in order to reduce the budget deficit. The gradual headway towards correcting its macroeconomic imbalances, reflecting a shift in economic policy priorities, has seen Türkiye's

3 See page 6 of the *Report on the Latin American economy,* Second half of 2023, Banco de España.

4 See pages 22 to 25 of the *Report on the Latin American economy,* Second half of 2023, Banco de España.

country risk indicators (for instance, sovereign spreads and 5-year sovereign CDS spreads) improve significantly since the last FSR was published.

1.1.2 Spain

The Spanish economy grew at a more moderate pace in early 2024, following the positive surprise in late 2023. Spanish GDP grew by 0.6% in 2023 Q4, up by 0.2 pp on Q3 and slightly more than the 0.3%[5] forecast in the Banco de España's December projection exercise. The most recent data point to activity growth of 0.4% in 2024 Q1, down slightly on three months earlier.[6]

Spain's favourable activity performance in 2023 was underpinned by various factors, notably including the resilience of private consumption. The latter grew despite the cumulative tightening of financing conditions, since the adverse impact of the latter was partly mitigated by improvements in households' real income, driven by the easing of inflation over the course of the year, robust employment and wage growth. Exports also improved, fuelled by the services component, despite global uncertainty and weak demand in several of Spain's main trading partners.[7] Conversely, investment showed a negative performance, especially investment by private agents. The fiscal policy stance appeared slightly contractionary in 2023, amid marked growth in both government consumption[8] and government revenue.

Looking beyond the first quarter, GDP growth rates are expected to hold relatively stable and higher than in the euro area. These will converge over the projection horizon towards rates consistent with the Spanish economy's growth potential. In annual average terms, GDP growth will slow from 2.5% in 2023 to 1.9% in 2024 and 2025, before declining slightly to 1.7% in 2026 (see Chart 1.3.a).

GDP growth will be underpinned by a number of factors over the coming quarters. These include the gradual fading of the adverse impact of monetary policy tightening on activity, the projected population growth, the gradual recovery of the European and global economy and the larger roll-out of NGEU funds.

However, some of the factors underlying the Spanish economy's relative strength during 2023 are expected to lose steam over the course of 2024. For instance, some of

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5 In addition, between the publication of the Banco de España's December macroeconomic projections and the publication on 26 March of the National Statistics Institute's (INE) revised Quarterly National Accounts (QNA) data for 2023, GDP growth in both the second and third quarter of 2023 was revised upwards by 0.1 pp, more than offsetting the slight downward revision in Q1. In 2023 overall, GDP grew by 2.5% (5.8% in 2022).

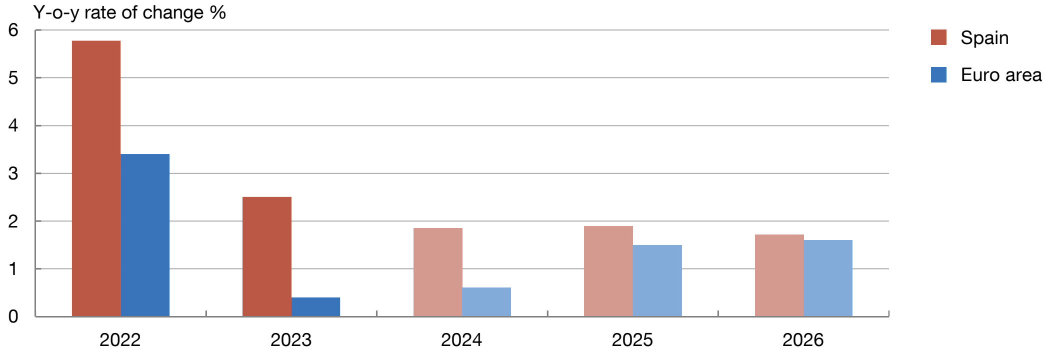
6 For more details, see "Macroeconomic projections for the Spanish economy (2024-2026)". In "Quarterly report and macroeconomic projections for the Spanish economy. March 2024" (in *Economic Bulletin* - Banco de España, 2024/Q1, pp 29-42). These projections were published on 12 March, before the revision of the 2023 QNA series published by the INE on 26 March. That revision entailed no notable changes to the GDP series available at the time of preparing those projections.

7 See pages 10 and 13 of the "Quarterly report on the Spanish economy". 2024/Q1.

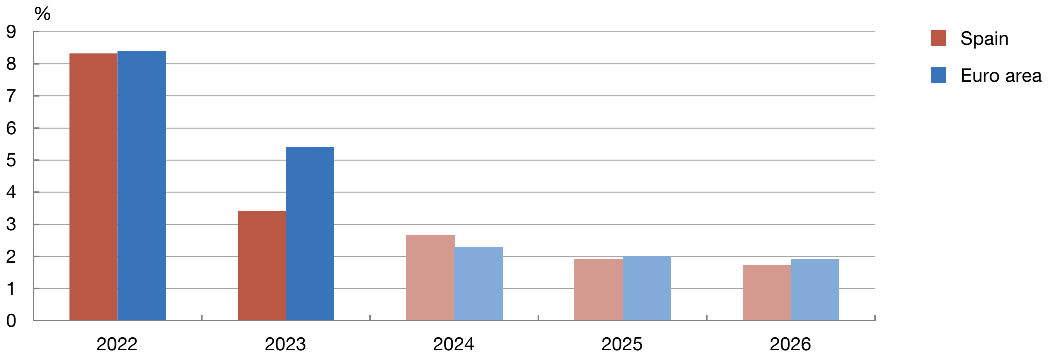
8 See page 23 of the "Quarterly report on the Spanish economy". 2024/Q1.

Chart 1.3
Forecasts point to Spanish economic growth moderating in 2024 (albeit holding above the euro area level) and inflation continuing its gradual decline

1.3.a Real GDP. Spain and the euro area (a)



1.3.b Inflation. Spain and the euro area (a)



SOURCES: ECB, Banco de España and INE.

a The faded bars denote the Banco de España and ECB's March 2024 macroeconomic projections for the period 2024-2026. The annual average change in the harmonised index of consumer prices (HICP).

the recent growth tailwinds (such as significant pent-up demand for certain goods and services and the sharp correction of some negative supply shocks that impinged on activity in 2021 and 2022) are expected to peter out. In addition, the persistence of considerable geopolitical tensions may weigh on the pace of activity growth going forward.

The projections envisage a continuation of the disinflationary trend in Spain. Following a slight increase in March, partly due to the partial reversal of the measures aimed at alleviating the effects of the crisis, in the coming months inflation is expected to return to a downward path (see Chart 1.3.b), reflecting a gradual moderation in food and underlying inflation, which will more than offset the increased contribution of the energy component.

The outlook for the Spanish economy under the baseline scenario remains highly uncertain, with risks to activity predominantly on the downside. The risks to inflation are more balanced, with the main downside risk being a stronger than expected slowdown in activity. The primary downside risks to activity stem from the external environment. As discussed in Section 1.1.1, an escalation of various global geopolitical conflicts could bear down on activity and generate greater inflationary pressures, undermining agents' confidence and economic expectations. On the domestic front, the return of the EU-wide fiscal rules (which had been suspended since the onset of the pandemic) is significant. Compliance with these rules will require the implementation of a medium-term fiscal consolidation plan (as discussed in Box 1.2), paving the way for a more pronounced reduction of the structural budget deficit than envisaged in these projections. This would probably mean weaker activity in the short term. In any event, the economic impact will depend on how the consolidation measures are designed.

1.2 Financial markets and the real estate sector

1.2.1 Financial markets[9]

The interbank market

Interbank market rates declined during the last six months amid expectations of policy rate cuts. Over this period, the central banks of the main developed economies have been ending policy rate hikes and holding rates at restrictive levels. In the final stretch of 2023 the markets sharply revised down the expected future path of policy rates, both in the United States and in the euro area. However, those expectations have been revised upwards in the early months of 2024, given the tone of central bank communications and positive surprises in some economic data. Following this back and forth, at the cut-off date for this report markets expect somewhat smaller policy rate cuts in 2024 than anticipated six months ago in the United States and slightly larger cuts in the euro area. Compared with the cut-off date for the previous FSR, the 12-month EURIBOR has decreased by 49 bp to stand at 3.7% in early April (see Chart 1.4.a).

Sovereign and corporate debt

Long-term yields on higher-rated sovereign debt have also declined, marking a shift from the performance observed last autumn. However, these declines were followed by an upward correction in the early months of 2024, in line with the expected path of policy rates. Over the last six months as a whole, the drop in long-term interest rates appears to reflect both the revised monetary policy expectations and a lower term premium. At the cut-off date for this report, yields on ten-year US and German sovereign bonds stood at 4.4% and 2.4%, respectively, down by 47 bp and 46 bp on the cut-off date for the last FSR.

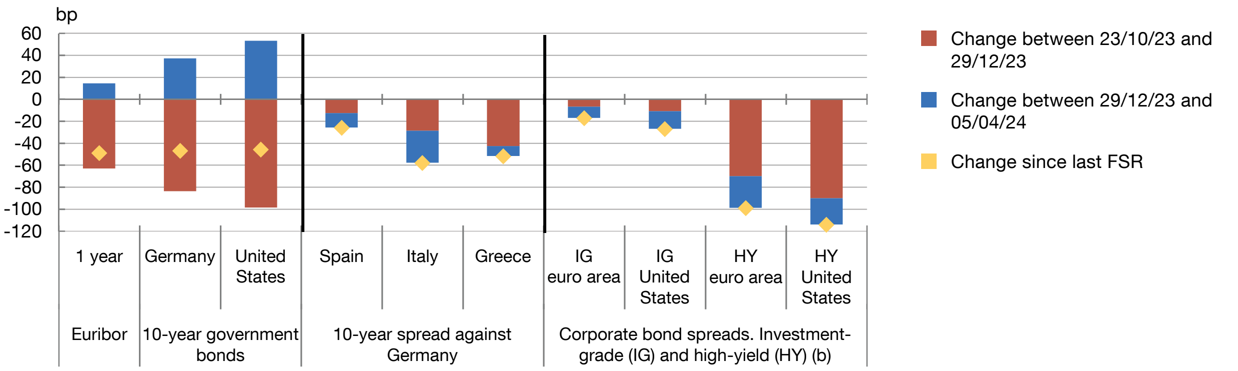
Likewise, sovereign spreads in the main euro area economies have contracted. The drop in long-term risk-free rates, which has a positive bearing on debt sustainability, appears to

9 Data cut-off date: 5 April 2024.

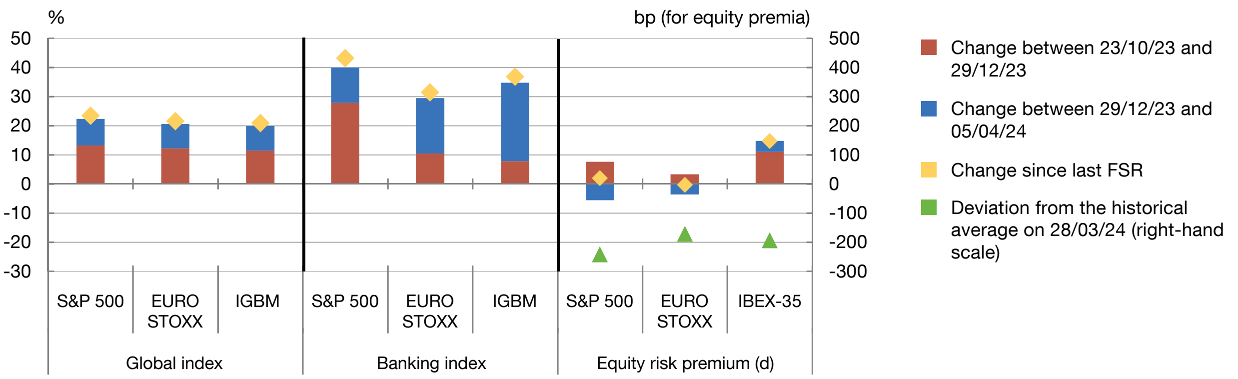
Chart 1.4

Yields on debt assets have declined while stock market prices have risen, amid expectations of lower policy rates, although these expectations partially corrected upwards since the start of 2024

1.4.a Euribor and debt yields (a)



1.4.b Stock market indices and equity premia (a) (c)



SOURCES: Refinitiv Datastream and Banco de España.

a The date 23/10/23 relates to the cut-off date for the last FSR. The cut-off date for this FSR is 05/04/24.
b Spreads over the swap curve of the ICE Bank of America Merrill Lynch indices.
c The change in the equity risk premium is shown on the right-hand scale and uses weekly data.
d The equity risk premium is calculated based on a two-stage dividend discount model (see Russell J. Fuller and Chi-Cheng Hsia. (1984). "A simplified common stock valuation model". Financial Analysts Journal, 40(5), pp. 49-56). The historical average, which refers to the period 2006-2024, is 496 bp for the S&P 500, 658 bp for the EURO STOXX and 781 bp for the IBEX-35.

have fuelled the narrowing of euro area sovereign spreads against the German benchmark, especially for those countries with higher government debt. For instance, the declines in sovereign risk premia were particularly marked in Italy and Greece, with cumulative falls of 58 bp and 52 bp, respectively, since the cut-off date for the previous FSR. The drop was likely also supported by the sovereign credit rating upgrades for these countries,[10] along with specific factors related to the German bond.[11] Spain's yield spread against Germany decreased by 26 bp over the same period, bringing it below 84 bp.

10 In early December Fitch upgraded Greece's sovereign debt rating to investment grade, while on 17 November Moody's raised Italy's rating outlook from "negative" to "stable".

11 The German ten-year sovereign bond yield has declined since the last FSR, albeit less than risk-free rates, proxied by the overnight index swap (OIS) rates. This apparently owes to such bonds becoming less scarce for use as collateral assets, reflected in a less negative risk premium relative to these OIS rates.

The credit risk premia on bonds issued by NFCs have also declined, while there has been a recovery in such fundraising. Corporate spreads relative to the swap curve have narrowed since end-October in both the euro area and the United States, in line with the drop in long-term risk-free rates. The fall has been particularly marked in the high-yield segment in both jurisdictions. Issuance in these markets was higher in 2023 than in 2022, both in the investment-grade and high-yield segments, and has remained robust in 2024 so far.

Equities and exchange rates

The main stock market indices have risen sharply since the cut-off date for the last FSR. This was driven by lower long-term interest rates, strong corporate earnings (especially in the United States) along with positive macroeconomic data. Thus, since the cut-off date for the previous FSR, the S&P 500 index has risen by 23.4% and the EURO STOXX by 21.5%, with both standing close to record highs (see Chart 1.4.b). The Chinese stock market has performed less robustly, conditioned by signs of economic weakness in the country. By sector, the gains have been broad-based, although cyclical stocks (those most closely linked to the consumption environment and, in particular, the technology sector, along with those related to artificial intelligence) have performed particularly well. The stock markets also made notable gains in 2023 as a whole. For instance, in the case of Spain, the IBEX 35 gained 22.8% value in the period.

Bank stock prices have also performed very favourably. As a result, the US banking index and the EURO STOXX Banks index exceeded levels seen prior to the turbulence of March 2023. In any event, despite also making gains, US regional bank stock prices remain below their March 2023 levels and there have even been sporadic stress episodes associated with specific banks in recent months. The Spanish banking sector has also made notable gains, with the IBEX 35 banking index rising 27.8% in 2023 as a whole and a further 27% in 2024 thus far.

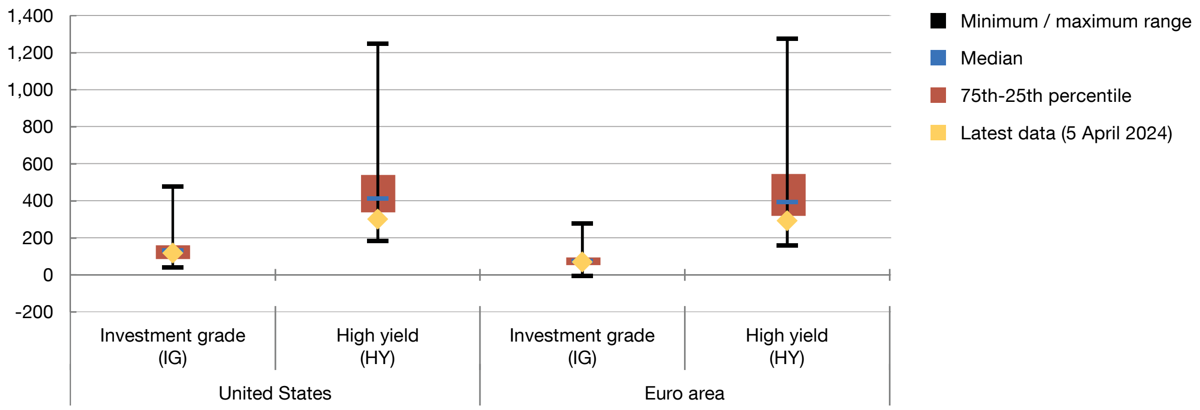
In the foreign exchange market, the US dollar has depreciated against the euro and the pound sterling in the period. These developments were initially driven by the shift in the US monetary policy outlook and greater risk appetite among investors. However, since early 2024 the depreciation of the dollar has partially corrected, supported, in part, by a more resilient US economy than expected.

Risks to financial stability

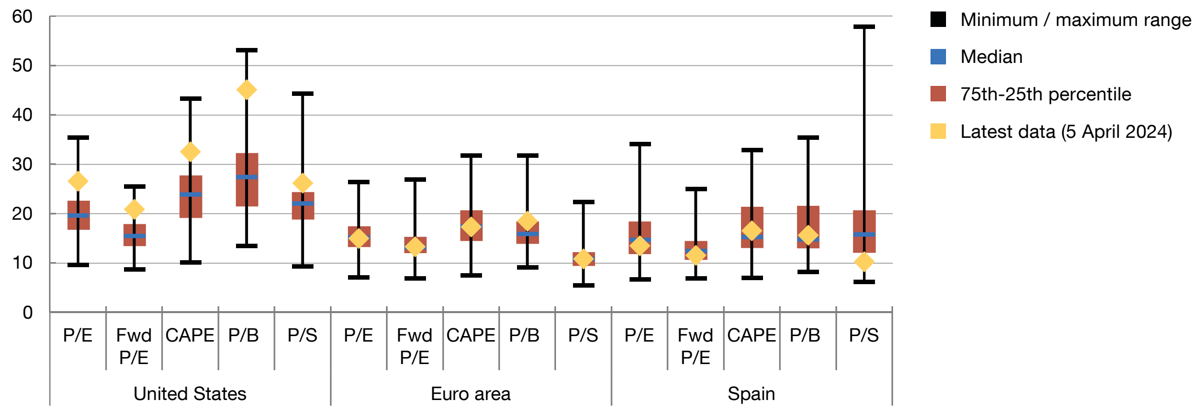
The materialisation of certain risks could trigger corrections in financial asset prices, particularly for higher risk assets. A scenario of more persistent than expected inflation could drive up expectations regarding the future level of policy rates, increase long-term yields and adversely affect the prices of risky assets, such as shares and corporate bonds. Risky asset prices could also decline should global economic growth be weaker than expected, due to the adverse impact this would have on firms' expected earnings and the increase in risk premia.

Chart 1.5
High-yield corporate bond risk premia stand at low levels and US stock valuation ratios are high by historical standards

1.5.a Corproate bond spreads (a)



1.5.b Stock market valuation ratios (b)



SOURCES: Refinitiv Datastream and Banco de España.

a Corporate spreads over the swap curve of the ICE Bank of America Merrill Lynch indices. Monthly series data since 1998.
b Drawing on monthly data of the stock market index series constructed by Datastream since 1985 for the euro area and the United States and since 1987 for Spain. The sample is somewhat smaller for Spain's CAPE ratio and the euro area Fwd P/E ratio. Ratios provided by Datastream, except the CAPE (cyclically adjusted price/earnings ratio) which is calculated as the value of the stock index in real terms (adjusted for CPI) divided by the 10-year moving average of the index firms' earnings in real terms. The price/earnings (P/E) ratio and 1-year forward P/E (Fwd P/E) ratio capture the relationship between the stock price and earnings per share (observed or expected). The price/book (P/B) and price/sales (P/S) ratios capture the stock market capitalisation of the firms divided by their book value (P/B) or sales (P/S) and have been multiplied by 10 for representation in this chart.

The current high prices of some risky assets entail a greater probability of corrections. Despite the elevated geopolitical tensions and the subdued outlook for global economic growth, stock price volatility is very low by historical standards. Moreover, high-yield corporate bond spreads have declined significantly since the cut-off date for the last FSR (see Chart 1.4.a), to stand at low levels compared with their historical median both in the euro area and in the United States (see Chart 1.5.a). In the equity markets, valuation ratios (stock prices relative to some of their underlying fundamentals) stand above the 75th percentile of the historical distribution in the United States, compared with ratios closer to their median in the euro area and Spain (see Chart 1.5.b). Equity premia, calculated using a dividend discount model, are well below the historical average in all three geographical areas (see Chart 1.4.b).

Such price corrections could be magnified if they materialise amid liquidity tensions. The possibility of fire sales by some intermediaries, such as international open-ended investment funds, with illiquid or highly leveraged positions, could trigger abrupt price movements for some assets.

1.2.2 The Spanish real estate market

House price growth moderated in the last quarter of 2023, while remaining above 4% year-on-year. According to the INE, the year-on-year house price growth moderated to 4.2% in 2023 Q4, down from 4.5% three months earlier (see Chart 1.6.a). New house prices rose by 7.5% year-on-year, less than the increase of 11% recorded in the previous quarter (the highest growth since 2007). By contrast, growth in second-hand house prices accelerated to 3.6% year-on-year, 0.4 pp higher than in the previous quarter. For both overall housing and the second-hand segment, the price increases observed in 2023 were significantly lower than in 2022, while price growth in new construction remained unchanged.

Upward pressure on house prices comes against a background of robust demand and relatively rigid supply.[12] The higher housing demand is linked to the number of households, in a setting of strong migration flows. Notable here is the increase in demand for rental housing, particularly in large urban areas. In the more popular tourist areas, housing demand has been boosted by the momentum of house purchases by non-residents. The pick-up in tourist rentals may also be having an impact on rental prices and, consequently, on house prices. In addition, the strong past increases in construction material costs could continue to feed through to the price of new housing, although this factor is likely to lose strength during 2024, insofar as these costs have tended to stabilise since mid-2022.[13] All this in a setting in which the supply of both new and second-hand housing is characterised by insufficient growth to meet the strong demand.[14, 15]

House sales have rebounded since late 2023, reversing part of the contraction recorded since 2022 H2. Despite the cumulative tightening of financing conditions, transactions signed before a notary increased, in seasonally adjusted terms, by 3% in 2023 Q4, with this positive trend continuing into early 2024 (see Chart 1.7.a). For 2023 as a whole, sales prices fell by 11% from the high levels reached in 2022, but were 12% above the figures recorded in 2019. The percentage of purchases by foreign citizens was slightly above 19% in 2023, higher than that observed in 2019 (nearly 17%) and close to the highest

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12 Andrés Lajer, David López and Lucio San Juan. (2024). "El mercado de la vivienda residencial en España en perspectiva: hechos estilizados y evolución reciente". Documentos Ocasionales, Banco de España. Forthcoming.

13 Changes in construction costs tend to be passed through to new house prices with a lag of almost two years, which is approximately the time it takes to build the houses.

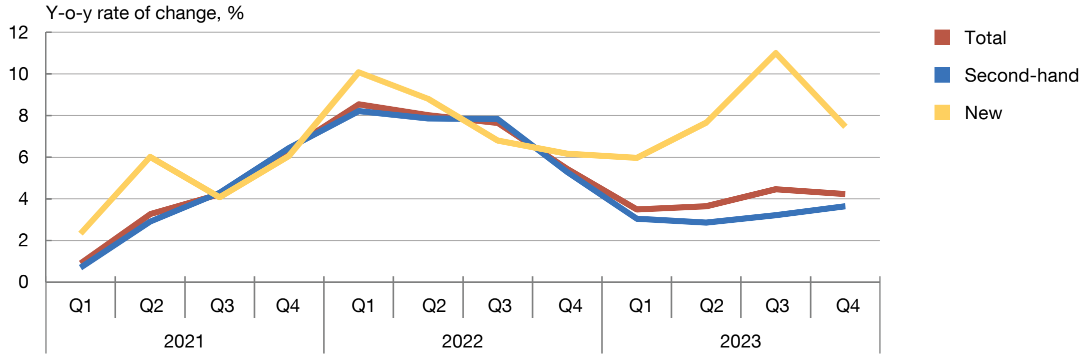
14 The supply of new housing, measured as the number of finished dwellings, stood at around 90,000 units in 2023, significantly below both its historical annual average since 1980 (270,000) and net household formation in 2023 (close to 270,000 units). In turn, the supply of second-hand housing, proxied by the number of listings on the leading real estate portals, stood at 700,000 units at end-2023, 3% lower than that observed a year earlier and 14% below the peak level reached in the final stretch of 2019.

15 For further details on housing supply and demand in Spain, and on the possible role public policies might play in the current juncture, see Chapter 4 of the Annual Report 2023 of the Banco de España, forthcoming.

Chart 1.6

Slight slowdown in house prices in the final stretch of 2023, although with sound year-on-year growth

1.6.a House prices

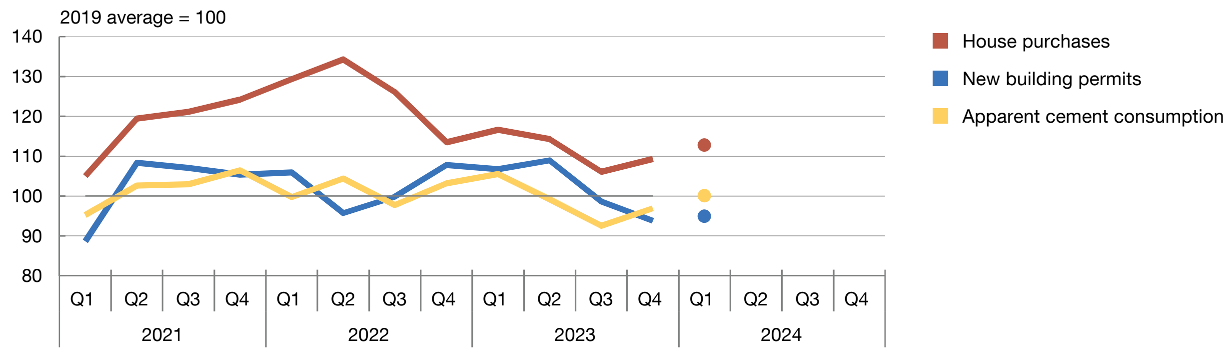


SOURCE: INE.

Chart 1.7

House purchases show notable resilience, while supply indicators lost momentum in 2023 H2

1.7.a Indicators of activity in the residential real estate sector (a)



SOURCES: Banco de España, INE, Ministerio de Transportes y Movilidad Sostenible and Ministerio de Economia, Comercio y Empresa.

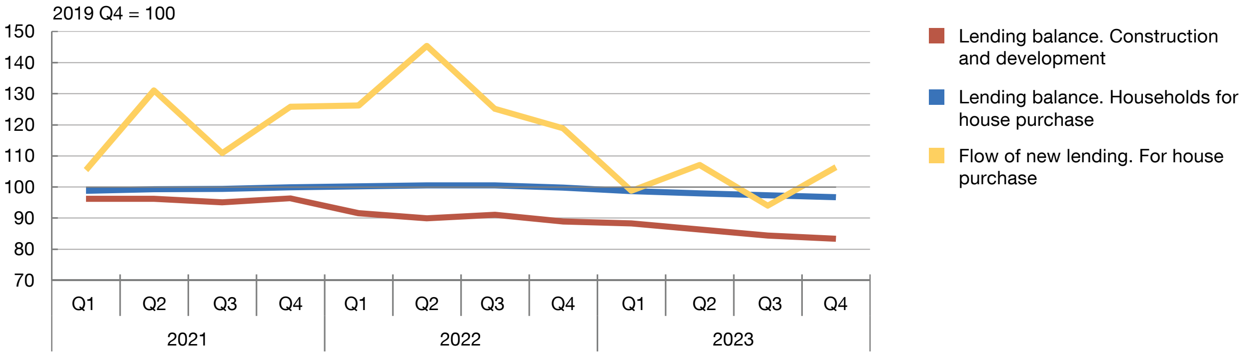
a Seasonally adjusted series. For 2024 Q1, an average of the last three months up to the latest one available is used (January for house purchases and building permits, and February for apparent cement consumption), as there are no data for the entire quarter.

percentage on record. This factor would also partly explain the gradual decline in the weight of house purchases financed by mortgage loans, since some foreign citizens would have other sources of financing available.

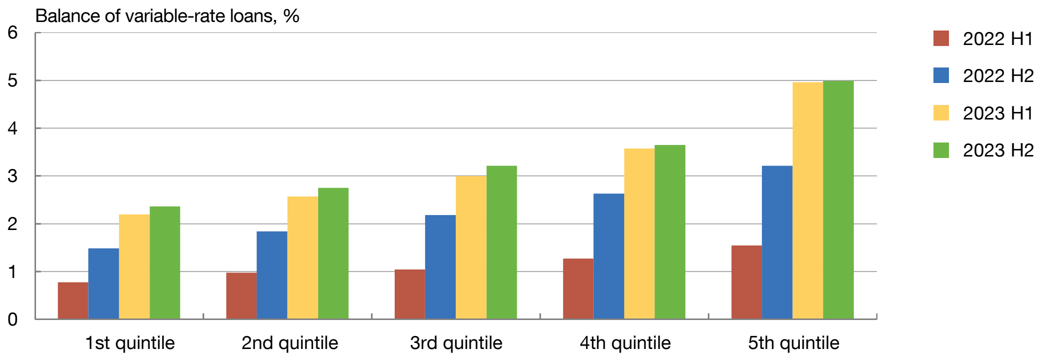
The flow of new residential mortgage lending also slowed its decline in 2023 H2. This flow declined by 10.5% year-on-year in 2023 Q4, far less than the declines in excess of 20% recorded in the first three quarters of the year. Despite the contraction in 2023 (see Chart 1.8.a), the annual volume of new residential mortgages is 16% above its pre-pandemic level in 2019.

Chart 1.8
The high volume of mortgage repayments seems to have contributed to a notable slowdown in lending in the real estate market compared with 2022

1.8.a Indicators of real estate sector financing (a)



1.8.b Early repayment of variable-rate mortgages by income quintile (b)



SOURCES: CIRBE and Banco de España.

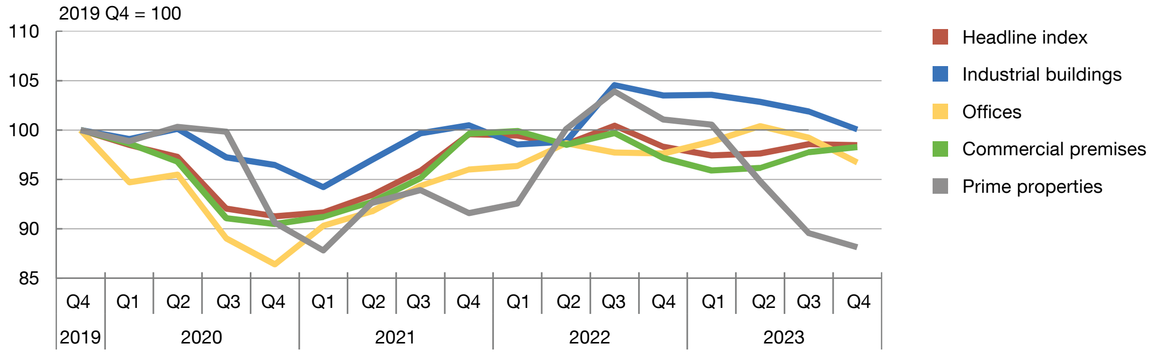
a Lending for construction and development includes real estate activities.
b Mortgages for house purchase. Household income is not observed and is imputed based on information on the distribution of income at postcode level provided by the INE. Specifically, the number of mortgages is the same and stable over time for each quintile.

The reduction in the stock of residential mortgage loans intensified in the second half of the year. Thus, the stock of such loans fell by 3.1% year-on-year in December 2023, compared with 2.6% in June 2023 (see Chart 1.8.a). In addition to the reduction in the flow of new credit, the high volume of mortgage repayments, particularly in the higher-income segments and in variable-rate mortgages, appears to have also contributed to this year-on-year decline (see Chart 1.8.b).

On the construction side, in 2023 H2 inputs in the construction sector and, especially, building permits, decreased (see Chart 1.7.a). Developments over the course of 2023 could have been partly influenced by uncertainty and, in the case of inputs, also by the adverse weather in the last stretch of the year. In the first few months of 2024 both figures are expected to remain somewhat subdued, based on recent developments in the orders component of the sector's confidence indicator.

Chart 1.9
The prices of commercial real estate assets have held steady, except in the prime segment, where they have fallen significantly

1.9.a Commercial real estate sector price indices (a)



SOURCES: Registrars Association and Banco de España.

a Based on estimates using a hedonic regression model for each stratum. The aggregate index is the average weighted by the relative share of transactions carried out in each segment (4% for offices, 78% for commercial premises and 18% for industrial buildings). In 2022 properties in prime locations, i.e. those located in central areas of the main large cities (Barcelona, Bilbao, Madrid, Malaga, Palma and Valencia), represented 4% of transactions conducted in the commercial real estate segment as a whole. For further details, see Matías Lamas and Sara Romaniega (2022), "Designing a price index for the Spanish commercial real estate market", Documentos Ocasionales, 2203, Banco de España.

The contraction in the stock of loans for development and construction intensified in 2023 H2. The year-on-year decline reached 6.2% in December and the cumulative fall since the start of the COVID-19 crisis is 17%, deepening the correction of 76% observed in the period 2008-2019 (see Chart 1.8.a).

In the commercial real estate segment, prices experienced minor changes in 2023 Q4, with the exception of properties in prime areas, whose prices have declined. The overall commercial property index remained relatively stable in 2023 Q4, standing 0.2% above its level a year ago (see Chart 1.9.a). By segment, the significant correction in the prices of properties located in prime areas, which recorded a fall of close to 13% year-on-year in 2023, stood out. The headline index and the other components (excluding the prime segment) remained close to, albeit generally somewhat lower than, their pre-pandemic levels, and their performance has been relatively stable since early 2022.

The stock market value of Spanish listed real estate investment companies (SOCIMIs, by their Spanish acronym) has partially recovered recently. The share prices of these companies have increased by 6% since the start of 2023 Q4, in line with developments in other European markets. However, the sector's stock market value remains close to 30% below pre-pandemic levels.

1.3 Non-financial sectors

1.3.1 Non-financial corporations and households

Non-financial corporations

Corporate earnings increased in 2023, but these increases moderated from Q2 onwards. In 2023 corporate earnings were driven by growth in turnover and profit margins. The acceleration in wage costs was cushioned by the fall or slowdown in other production costs (commodities and energy, among others). Thus, according to the Spanish tax revenue service (AEAT), firms' gross operating profit (GOP) is estimated to have increased in 2023 by 7% in nominal terms (compared with 30% the previous year), with a substantial slowdown from Q2 onwards (see Chart 1.10.a). The breakdown by sector shows heterogeneity, with a notable improvement in the construction and real estate activities sector and a less marked slowdown in the wholesale and retail trade and hospitality sector.

The balance of corporate debt continued to decline sharply. The balance of financing granted to firms contracted by over 1% year-on-year in February. This, together with income growth, led to a notable decline in the corporate debt ratio. Specifically, the aggregate debt-to-GDP ratio stood at 65% of GDP at end-2023, a level not seen since 2002 and almost 3 pp lower than the euro area average. The sample of firms in the Banco de España's Central Balance Sheet Data Office Quarterly Survey (CBQ) also reflected a decline in the debt-to-earnings ratio for this sample as a whole, as well as for the different debt percentiles. Also, the percentage of CBQ firms with high indebtedness[16] decreased to 18.2% in 2023 Q4, down from 20% in 2022 Q4.

Despite positive developments in activity and lower indebtedness, rising interest rates have pushed up the debt burden of firms. In particular, according to the National Accounts, interest payments by NFCs stood at more than 16% of gross operating surplus (GOS) in 2023 Q4, nearly doubling the figure for the same quarter in 2022 (see Chart 1.10.b).

The pass-through of tighter monetary policy to interest payments on variable-rate loans seems to have been completed by end-2023. Given the decline in interbank rates since October 2023, and with the market expecting this process to continue, an increasing share of variable-rate loans[17] is likely to undergo interest rate reductions in 2024.[18] In any event, market expectations point to interest rates remaining at levels considerably higher than in 2021, before the monetary tightening cycle. As a result, although interest rates on new loans have already started to decline, part of the fixed-rate loans that will have to be rolled over at

16 Firms are understood to be highly indebted when their ratio of net financial debt to (GOP + financial revenue) is higher than 10, or they have positive net financial debt and zero or negative earnings.

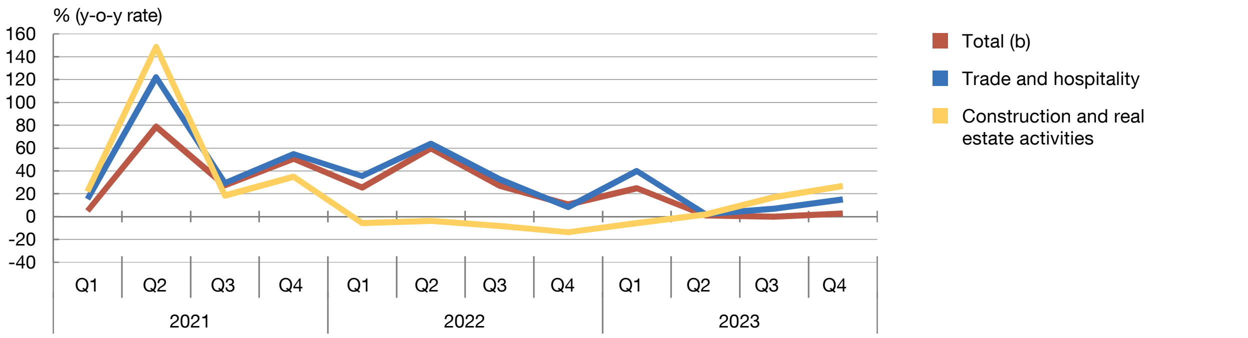
17 Variable-rate loans account for around 70% of firms' bank lending.

18 See "Box 1. Monetary policy transmission to interest payments on the bank debt of households and firms". In Banco de España, *Report on the financial situation of households and firms,* Second half of 2023, pp 25-28.

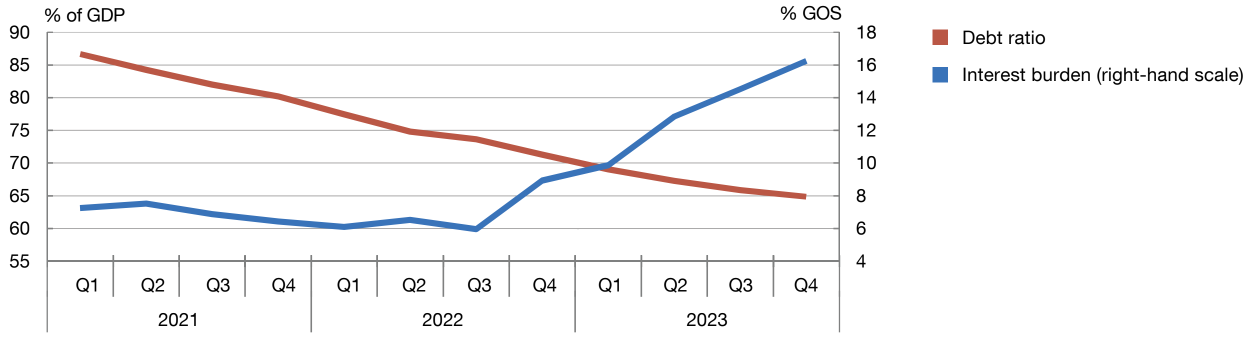
Chart 1.10

Corporate earnings have slowed. The interest burden has grown, despite the decline in indebtedness, and the percentage of firms under financial pressure appears to have increased moderately

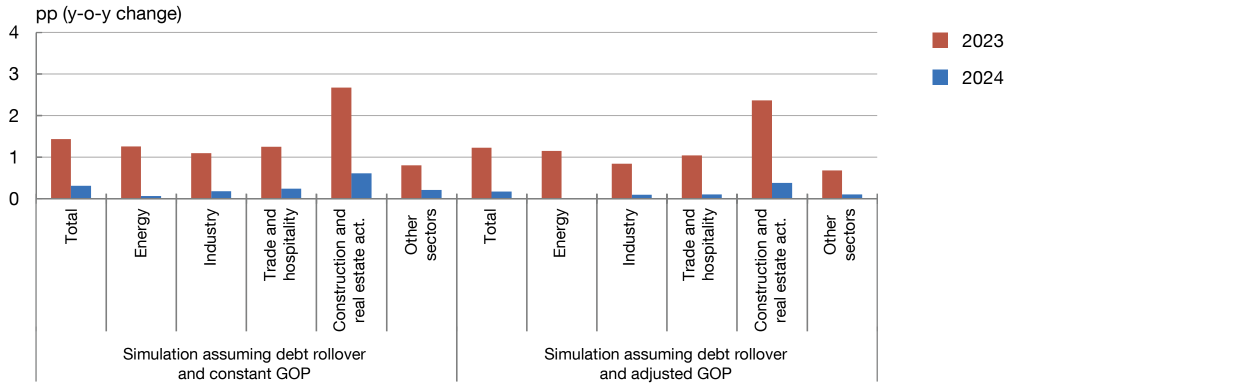
1.10.a GOP of Spanish NFCs. AEAT (a)



1.10.b Debt ratio and interest burden (c)



1.10.c Expected change in the percentage of firms under high financial pressure (d)



SOURCES: AEAT and Banco de España.

a GOP is obtained by subtracting intermediate consumption and personnel costs from output. Seasonally adjusted data.
b The following sectors are not included: education, health, public administration, recreation, financial and insurance institutions and other services.
c Interest payments are quarterly, before allocation of financial intermediation services indirectly measured (FISIM) and are not seasonally adjusted. Gross operating surplus (GOS) is quarterly and seasonally adjusted.
d A firm is considered to be under high financial pressure when its (GOP + financial revenue) / financial costs ratio is lower than 1. The financial costs of each firm for 2023 and 2024 are proxied based on the balance of interest-bearing debt and the expected path of interest rates. 2023 data are observed data for CBQ firms. For other firms, under the updated GOP scenario, profits increase by 6.4% in 2023 (growth observed in AEAT data) and by 3.7% in 2024, in line with the growth in underlying GOS in the Banco de España's latest macroeconomic projections. Holding companies, head offices and dormant firms are excluded. For more details on the methodology, see "Box 2. The impact of interest rate hikes on firms' financial pressure". In Banco de España, *Report on the financial situation of households and firms,* Second half of 2023, pp. 29-31.

maturity are expected to increase in cost, as they were granted prior to the last monetary tightening cycle.

Financial vulnerability indicators associated with the higher interest burden point to some deterioration, although there is heterogeneity across sectors. According to the simulations carried out by the Banco de España, the percentage of firms that were unable to cover their debt interest payments out of ordinary earnings[19] (firms under high financial pressure) increased moderately in 2023.[20] This increase is somewhat sharper in the construction and real estate sectors, assuming that firms rolled over the entirety of their debts in 2023 (see Chart 1.10.c). See Box 3.1 for a deeper analysis of the bank debt burden of firms in this sector. Taking into account market expectations as at January 2024 for interest rate developments, the share of debt held by firms under high financial pressure would practically stabilise by 2024. However, a more pronounced economic slowdown than that underlying this simulation exercise, and than envisaged in the baseline economic projections, could increase the number of vulnerable firms, especially if interest rates fall less than envisaged in the assumption underlying this exercise.

Households

Employment growth, wage growth and public sector support continued to sustain household income growth in the second half of 2023. Thus, year-on-year employment growth averaged 3.5% in 2023 H2, while compensation per employee increased by 5.1%. Adjusted for inflation and the number of households,[21] gross disposable income (GDI) grew on average by 5.5% year-on-year in H2 (slightly below the 5.9% change recorded in H1). Despite these developments, in 2023 real GDI per household still stood slightly short of pre-pandemic levels (1.1% lower). Meanwhile, households' perceptions of their future economic situation deteriorated slightly in late 2023, followed by a correction in 2024 Q1, to stand at levels very similar to those seen in mid-2023 across all income brackets. (see Chart 1.11.a).

The financial position of households has continued to strengthen. The debt-to-GDP ratio stood at 47% of GDP in 2023 Q4 (see Chart 1.11.b), the lowest level since 2001 and 4 pp below the euro area average. This decline has been supported by both lower outstanding debt balances and by inflation and higher real income. Gross household wealth grew by 4.7% year-on-year at end-2023, driven by rising house and financial asset prices.[22]

Despite the decline in the indebtedness of the sector as a whole, interest payments continued to increase until end-2023. Income growth has mitigated the increase in the debt

19 For the purposes of this indicator, ordinary earnings are calculated excluding financial costs, as the sum of GOP and financial revenue.

20 See "Box 2. The impact of interest rate hikes on firms' financial pressure". In Banco de España, *Report on the financial situation of households and firms,* Second half of 2023, pp. 29-31.

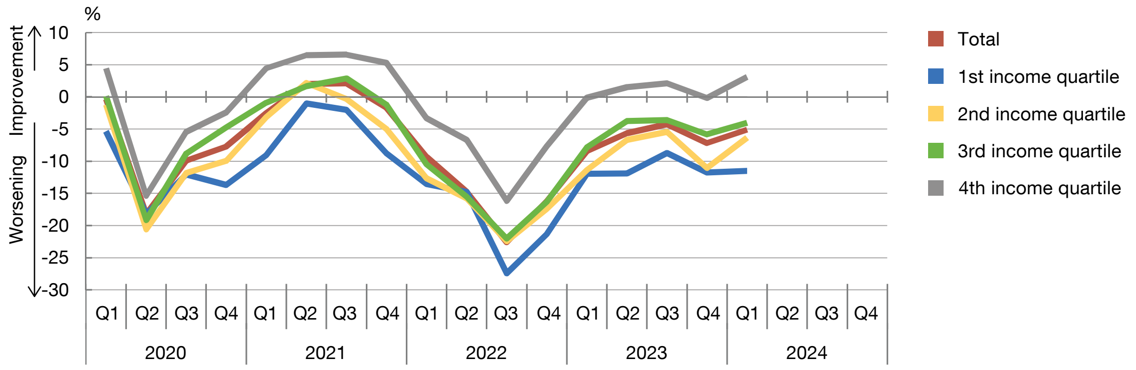
21 The consumer price index (CPI) has been used as an income deflator. In 2023 the number of households grew by 1.5%.

22 According to the ECB's experimental statistics on the distribution of household wealth (for 2024 Q3), deleveraging has been widespread, but was more intense for households in the bottom 50% of the net wealth distribution. Gross wealth also increased across the board, although more moderately for households whose net wealth is in the top deciles.

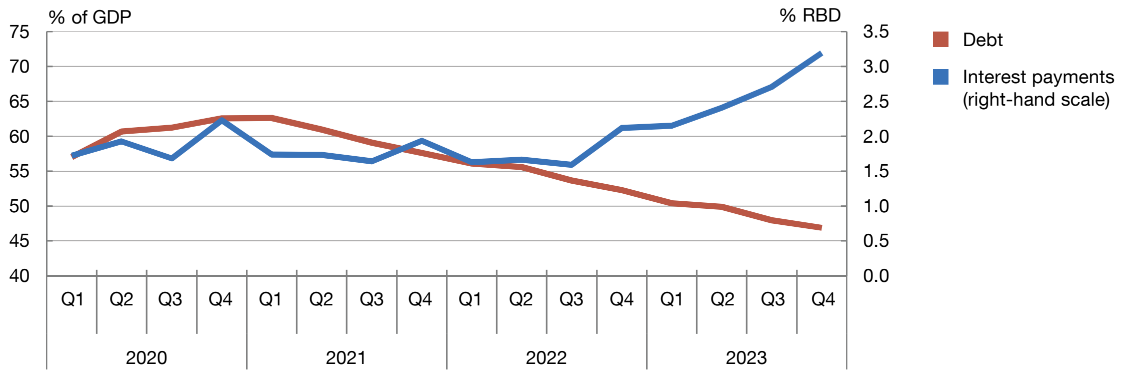
Chart 1.11

Households' economic outlook remains stable. Despite a reduction in debt, the interest burden has grown, albeit with only a limited rise in the share of households with a high interest burden

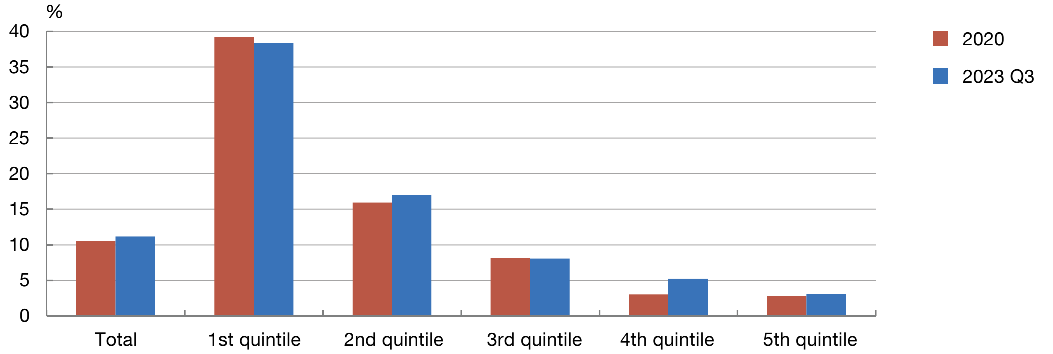
1.11.a Households' expectations for their own financial situation over the next 12 months (a)



1.11.b Debt and interest payments (b)



1.11.c Simulation of the percentage of indebted households with a high interest burden, by income quintile (c)



SOURCES: European Commission, INE and Banco de España.

a Consumer Confidence Survey. Indicator = percentage of households expecting their economic situation to improve significantly over the next 12 months × 1 + percentage expecting their economic situation to improve somewhat × 1/2 - percentage of households expecting their economic situation to worsen somewhat × 1/2 - percentage expecting their economic situation to worsen significantly × 1.

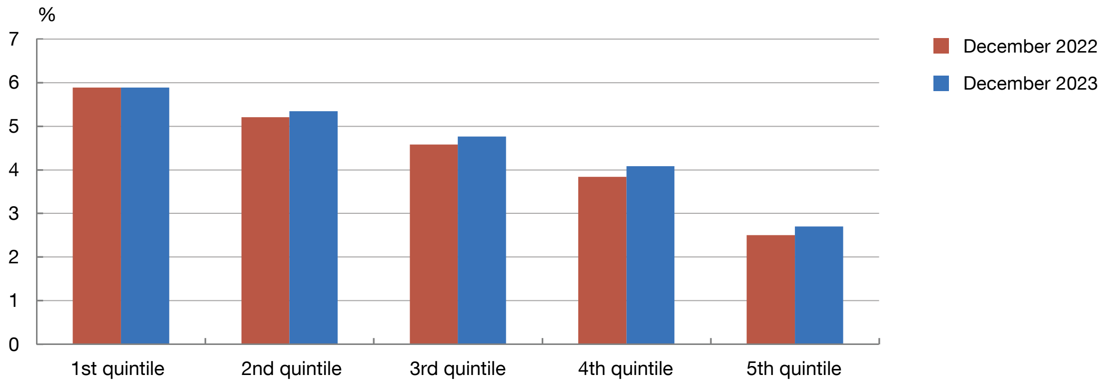
b Interest payments are quarterly and are neither adjusted for the allocation of financial intermediation services indirectly measured (FISIM) nor seasonally adjusted. GDI is quarterly and seasonally adjusted.

c Drawing on the 2020 Spanish Survey of Household Finances. Interest burden is considered high when debt service costs exceed 40% of household income. 2023 figures estimated under a scenario of a cumulative interest rate rise from 2020 of 466 bp and a 15.6% increase in household income.

Chart 1.12

The increase in the non-performing loan ratio has been highly contained across all income quintiles

1.12.a Non-performing ratio for residential mortgage loans. By income quintile (a)



SOURCES: INE and Banco de España.

a For each date and income quintile, the non-performing loan ratio is defined as the outstanding balance of non-performing credit (including due to arrears and for subjective reasons) as a proportion of total credit. The distribution by income quintiles is approximated by assigning to each borrower the gross household income by postcode provided by the INE. The upper limit of the first income quintile is lower than €28,000 and the lower limit of the highest quintile is more than €41,000. The income levels are for 2021 (latest data available).

burden (see Chart 1.11.b). According to the simulations carried out by the Banco de España for a scenario involving an increase in interest rates of 466 bp,[23] and adjusting for the average increase in income, the percentage of indebted households with a high gross debt burden (more than 40% of household income) rose by only 0.7 pp between 2020 and 2023 Q3, to 11.2% (see Chart 1.11.c).[24] By income level, the percentage of indebted households with a high debt burden in the first quintile decreased, while the most affected quintiles were the second and fourth (with increases of 1.1 pp and 2.2 pp). This reflects both differences in debt levels and in the percentage of households with variable-rate debt.[25] In any event, the results of this simulation should be interpreted with caution, as households also have to face the rising costs of other essential expenditures. In addition, the simulation exercise assumes a similar increase in income between 2020 and 2023 for all households and equal to that observed in the sector's aggregate data, which could also lead to some measurement error.

Against this backdrop, the non-performing ratio for residential mortgage loans has seen very moderate increases in 2023 for most income quintiles. Note, in any case, that this ratio is uneven across income levels, and has an inverse relationship with income. Thus, as at

23 This figure represents the peak increase in the twelve-month EURIBOR (the key reference rate for mortgages) during the recent monetary tightening cycle.

24 The difference in the magnitude of these results compared with the ones presented in the Spring 2023 Financial Stability Report is due to the inclusion in the new simulations of an income assumption, while the previous simulations focused purely on interest rate sensitivity.

25 According to the Spanish Survey of Household Finances 2020, the percentage of indebted households with some form of variable-rate debt is approximately 30% for the first income quintile, 40% for the second income quintile and 47%, 60% and 66% thereafter.

December 2023, the non-performing loan ratio for residential mortgage loans ranged between 5.9% for the first quintile and 2.7% for the fifth income quintile (see Chart 1.12.a). The systemic importance of the higher non-performance in the lower quintiles is limited by the fact that the two top income quintiles account for around 75% of mortgage lending.

The pass-through of higher policy rates to the cost of outstanding mortgages appears to have been virtually completed by end-2023. Given recent developments and market expectations for interbank rates, the cost of outstanding mortgages should start to fall in 2024.[26] In any event, expectations suggest that interest rates will not return in the coming years to the levels observed in 2021, before the monetary tightening cycle.

1.3.2 General government in Spain

The budget deficit declined further in 2023. For the year as a whole, the deficit stood at 3.6% of GDP, below the government's target of 3.9% and 1.1 pp lower than that recorded in 2022 (see Chart 1.13.a). Government revenue continued to grow at a brisk pace in 2023 (9%), driven by higher wages and employment, and by the entry into force of new taxes[27] and higher social security contributions.[28] Government expenditure also grew substantially, spurred by pension revaluation and the maintenance of some expenditures that had been introduced on a temporary basis in the early stages of the COVID-19 pandemic. Overall, it is estimated that the structural component of the deficit decreased by 0.5 pp, to 3.7% of GDP.

The government debt-to-GDP ratio decreased by around 4 pp to 107.7% of GDP. This decline reflects the growth of nominal GDP. The level is 13 pp below the 2020 peak, but 9 pp above that observed before the pandemic (see Chart 1.13.b) and 17 pp (34 pp) above the weighted (arithmetic) mean in the euro area.[29]

The average cost of general government debt has increased slightly from its 2022 level. The higher cost of new issuance was largely offset by lower interest rates on inflation-linked bonds. The latter were very high in 2022, when the standard benchmark inflation rate – the euro area Harmonised Index of Consumer Prices (HICP) excluding tobacco – exceeded 10%, compared with 2.8% in 2023.[30] By contrast, the cost of non-indexed new issuances increased significantly, to 3.4% for Treasury securities (2.1 pp more than in 2022 and 3.5 pp more than

26 See "Box 1. Monetary policy transmission to interest payments on the bank debt of households and firms". In Banco de España, *Report on the financial situation of households and firms,* Second half of 2023, pp 25-28.

27 Extraordinary taxes on financial corporations and energy utilities, the wealth tax, taxes on plastic containers and on landfill waste, as well as corporate income tax changes (a minimum rate of 15% and a limit to deductions for offsetting losses at subsidiaries).

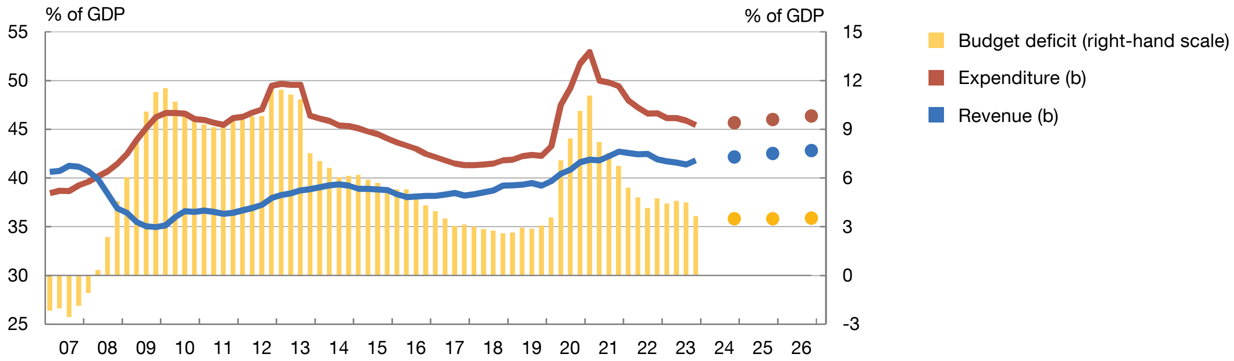
28 As a result of the pension reform.

29 The latest European Commission forecasts, published in November 2023, are used for the euro area.

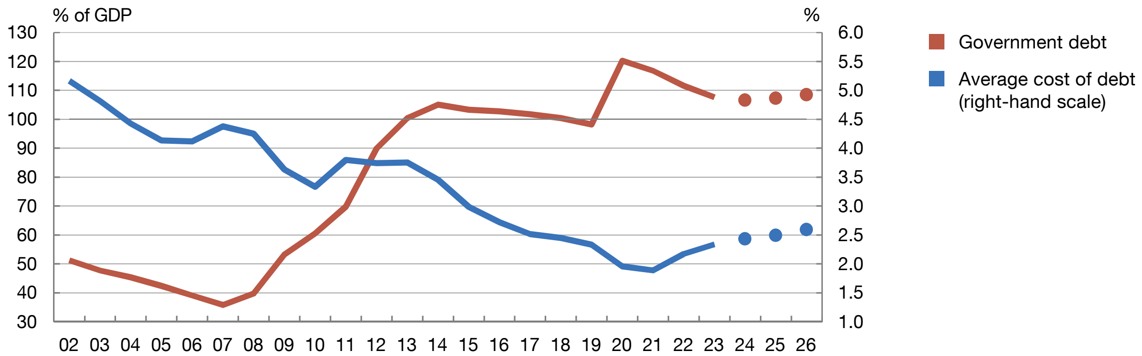
30 At the end of 2022, inflation-linked bonds accounted for 5% of total general government debt. However, in terms of interest accrued in that year, they accounted for around 25% of the total. This discrepancy is explained by the fact that inflation affects not only coupons, but also the principal that will have to be repaid in the future, and in the National Accounts the increase in principal is considered accrued interest for the year in which the change in the principal occurs.

Chart 1.13
Growing spending demands and the rising cost of debt warrant a fiscal consolidation process in Spain

1.13.a Budget balance in Spain (a)



1.13.b Government debt in Spain and its average cost (a)



SOURCES: IGAE and Banco de España.

a The circles denote the Banco de España's March 2024 macroeconomic projections, which were prepared before the publication of the final data for 2023. These entailed an upside surprise in government revenue (and the budget balance) of 0.2 pp of GDP and minor changes in government expenditure and debt. The average cost of debt in 2023 stood at 0.1 pp above the figure forecast in March.
b Excluding estimated NGEU funds, which temporarily increase revenue and expenditure, but have no effect on the deficit.

in 2021). However, since the average life of public debt is close to eight years (and thus the volume of new issuances has a limited weight in the total) and maturing debt was generally issued at higher interest rates than the current ones, the sharp increase in issuance costs in the last two years has only resulted in an increase of 0.4 pp in the average interest rate on debt, to 2.3%.

Over the next few years, the average cost of debt will continue to rise. While issuance rates could fall from the 2023 levels, they will likely remain high relative to the levels observed over the past ten years. According to the Banco de España projections – based on interest rate expectations in the financial markets – this average cost is set to increase by around 0.3 pp over the next three years, to 2.6% in 2026.[31]

31 However, a hypothetical 100 bp increase in market rates, in both the short and long term, would raise this increase to 0.8 pp, bringing the public debt interest burden to 3.1% of GDP in 2026, 1 pp more than in 2021.

In addition to the higher debt burden, there will be other upward pressures on public spending. These pressures will contribute to the rising path projected for the government expenditure-to-GDP ratio (see Chart 1.13.a). The pressure on public spending will remain high in the coming years, as a result of various structural phenomena, such as the impact of demographic ageing, investment needs related to climate change, digitalisation and the defence commitments undertaken in the face of geopolitical tensions.

Overall, public debt in Spain will likely be on a rising path in the medium and long term if a fiscal consolidation process spanning several years is not implemented (see Chart 1.13.b). The consolidation process required must take into account pressures on the spending side, and prioritise revenue and spending measures that will foster economic growth.

The fiscal consolidation process must comply with the EU's new fiscal rules (see Box 1.2). The current cyclical position of the Spanish economy and the vulnerability of the country's public finances justify initiating the fiscal consolidation process this year.

1.3.3 Financial flows vis-à-vis the rest of the world and the international investment position

In the second half of 2023 the Spanish economy continued to show significant net lending capacity, while placements of debt on international markets increased. In particular, foreign investment by residents was concentrated on repo transactions by resident monetary financial institutions. By contrast, investment by non-residents in Spain mainly took the form of purchases of long-term debt issued by monetary financial institutions and general government. This net lending position, together with the net inflow of funds into sectors other than the Banco de España, was reflected in a 20% decrease in the central bank's net external liabilities.

As a result, Spain's negative net international investment position (IIP) continued to decline. As a percentage of GDP, the IIP decreased by 3.7 pp in H2, to 52.8% in December, underpinned by net transactions and nominal GDP growth. By contrast, changes in the value of financial instruments offset this decline, mainly owing to the appreciation of the euro in 2023 Q4 (see Chart 1.14.a). This is the lowest level since the start of 2004, but remains well above the threshold set in the macroeconomic imbalances procedure (35%) and far from those of the main euro area economies.[32]

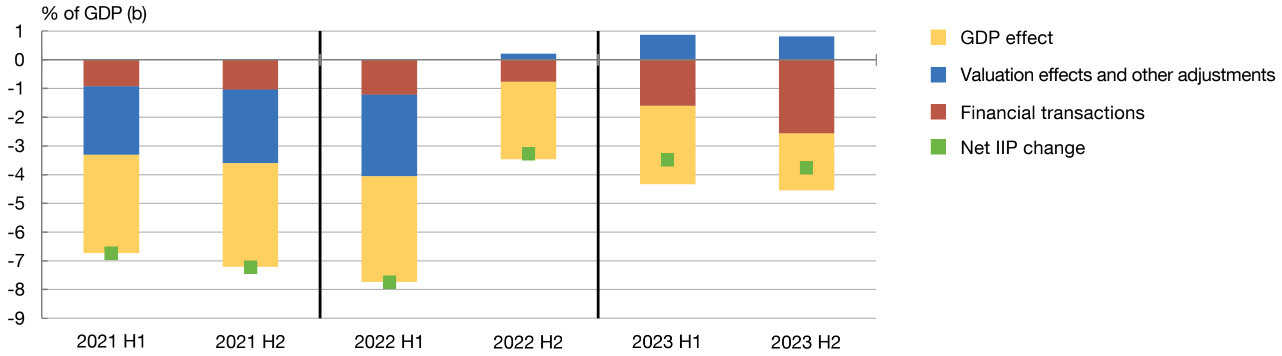
Likewise, Spain's gross external debt ratio continued its downward path in the second half of the year, reaching 165.5% of GDP (see Chart 1.14.b). This reduction reflected the increase in nominal GDP, as the outstanding amount of debt increased (by €45 billion), as a result of the increase in the stock of debt issued by general government and monetary financial institutions, due to both new investments and increases in market value. In any event, the high

32 Germany and Italy have a positive net IIP and France has a negative net IIP of 28% of GDP.

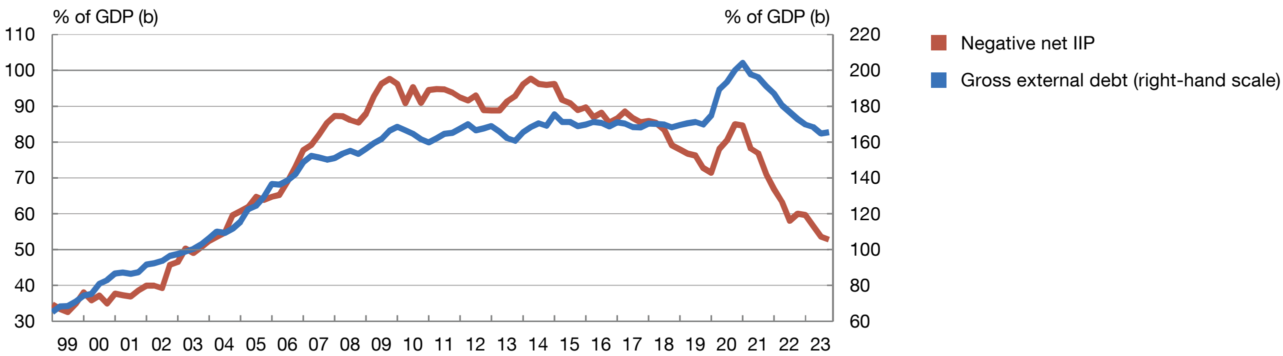
Chart 1.14

Foreign imbalances continue to correct, underpinned by the Spanish economy's net lending and nominal economic growth

1.14.a Change in the negative net international investment position (IIP) and determinants (a)



1.14.b Negative net IIP and gross external debt (a) (c)



SOURCES: IGAE and Banco de España.

a Negative net IIP is the difference between the value of national liabilities vis-à-vis the rest of the world and resident sectors' foreign assets.
b Four-quarter cumulative.
c Gross external debt comprises all liabilities included in the international investment position except equity and financial derivatives.

volume of external debt (€2,419 billion) of the Spanish economy continues to be an element of vulnerability, particularly given that potential refinancing will be carried out in a setting of higher interest rates. However, the composition of these liabilities (with long average repayment terms) and the fact that 27% are general government debt and 22% are liabilities of the Banco de España (which do not have an explicit maturity) continue to mitigate part of this risk.