BANCO DE ESPAÑA
Eurosistema

ECONOMIC BULLETIN
2024/Q1

https://doi.org/10.53479/36150

12/03/2024

Quarterly report and macroeconomic projections for the Spanish economy. March 2024

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EDITORIAL

Editorial

In recent months global economic activity has shown signs of stabilisation and the disinflation process has continued worldwide, with some regions even seeing prices slow somewhat more quickly than forecast. In a setting in which considerable sources of geopolitical uncertainty persist, these favourable macroeconomic developments (particularly evident in the United States) are above all the result of the continued strength of the labour markets in the different economies and the ongoing sharp correction in energy prices.

Looking ahead to the coming quarters, the global economic and financial outlook is relatively positive. Global growth forecasts for 2024 have been revised up slightly in recent months, although they envisage modest growth rates by historical standards and incorporate a gradual slowdown in activity in the United States and China. Meanwhile, inflation is expected to continue to ease, although somewhat less sharply than in recent quarters. Against this backdrop, the cumulative monetary tightening in response to the inflationary process would continue to have a relatively low impact in terms of dampening activity and the labour market.

In line with this outlook, global financial markets are counting on policy rate cuts by the main advanced economies' central banks being around the corner, which has given rise to more favourable financial conditions. Investor expectations for when and by how much central banks will cut rates vary over time, depending, among other factors, on incoming macro-financial information and communication by the central banks themselves. In this respect, although expectations for the future path of policy interest rates have been revised upwards slightly in recent weeks, this path has shifted downwards since the cut-off date for the December Banco de España projections exercise.

Set against these global developments, the euro area remains one of the regions where economic activity is clearly weaker and where the short and medium-term outlook is for a more subdued recovery. Weak economic activity and the more pronounced than expected disinflation in the euro area in recent quarters could indicate stronger than expected monetary policy transmission, but also longer-lasting effects (e.g. via a deterioration in international competitiveness) of the energy crisis, to which the euro area has been more exposed than other regions of the world. In any event, the European Central Bank's March projection exercise envisages a gradual recovery in euro area activity over the coming quarters, although a somewhat weaker one than forecast in December. This recovery will mainly be underpinned by private consumption, buoyed by the increase in households' real disposable income amid rising wages and falling inflation.

Against this background, Spanish economic activity – which had been outstripping that of the euro area – has in recent months grown faster than initially expected. According to the

Quarterly National Accounts (QNA) flash estimate published by the National Statistics Institute (INE) last January, in 2023 Q4 the Spanish economy accelerated unexpectedly, recording quarter-on-quarter growth of 0.6%, compared with the 0.3% projected by the Banco de España in December. The INE also revised up slightly the rates of change of GDP for the second and third quarters of 2023 at the same time.

However, the breakdown of the growth observed at end-2023 hints at some weaknesses, while the latest short-term economic indicators suggest that the GDP growth rate has slowed slightly in 2024 Q1, to 0.4%. The information in the QNA flash estimate suggests that the main upward surprises in recent economic developments in Spain are associated with the momentum of government consumption and stockbuilding. By contrast, gross fixed capital formation and private consumption, which are typically the main underpinnings of stable growth for any economy, have performed worse than expected. Meanwhile, productivity remains considerably weak, which could constrain economic growth in the medium and long term. In addition, sluggish productivity appears to be partly contributing to a rise in unit labour costs, which could result in domestic inflationary pressures persisting for longer and possible international competitiveness losses.

Nevertheless, compared with the December projections, GDP growth in 2024 has been revised up by 0.3 percentage points (pp), to 1.9%, and is unchanged in 2025 (1.9%) and 2026 (1.7%). The main factors behind the revised average growth rate for 2024 are the new QNA figures for recent quarters, the lower energy prices of recent months, a more favourable outlook for the future path of energy prices and the partial extension, which was not expected in the December projections, of some of the measures deployed by the authorities to tackle the effects of the inflationary episode. Excluding the revised QNA figures, these same factors are, in turn, the main determinants of the downward revision, of 0.6 pp, to 2.7%, to the average headline inflation rate projected for 2024. All this in a setting in which the disinflation process is expected to continue over the coming years, falling to 1.9% in 2025 and 1.7% in 2026.

The risks to the baseline scenario presented in this Quarterly Report are tilted to the downside with regard to activity and balanced with regard to inflation. Aside from the uncertainty stemming from the geopolitical tensions and from quantifying the macroeconomic impact of the cumulative monetary tightening, on the domestic front the risks to the March projections' baseline scenario posed by the reactivation of the European fiscal rules should also be highlighted. Specifically, compliance with these rules will require the design and implementation of a medium-term fiscal consolidation plan that lays the foundations for a more pronounced correction of the structural budget deficit than envisaged in the projections. Although the economic consequences of this adjustment plan remain uncertain, and will critically depend on its design, its implementation would likely result in lower levels of activity over the projection horizon than envisaged in the projection exercise.

Figure 1

	2024	2025	2026
GDP	1.9% ↑ 0.3 pp	1.9% =	1.7% =
Inflation	2.7% ↓ 0.6 pp	1.9% ↓ 0.1 pp	1.7% ↓ 0.2 pp

SOURCE: Banco de España.

REPORT

1 Global economic activity shows signs of stabilisation with upward revisions to growth forecasts for the United States

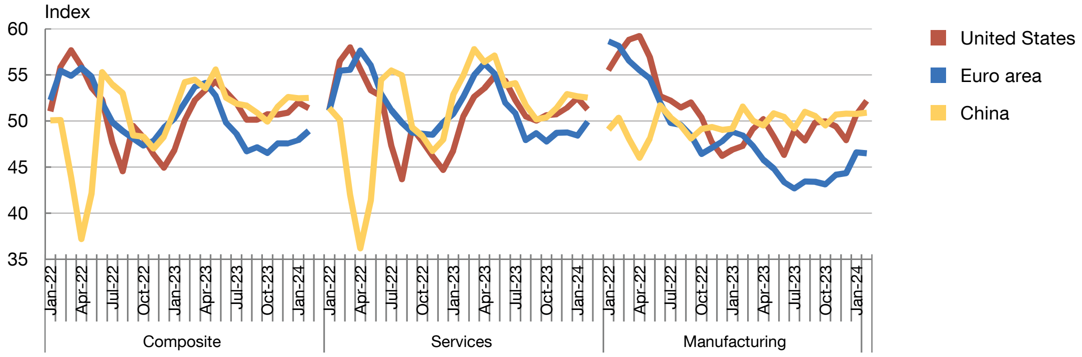
— Global growth at end-2023 was higher than expected, especially in the United States, where private consumption was the most dynamic component of demand, underpinned by the positive performance of employment, real income gains in response to lower inflation, the fiscal impulse and the use of savings built up during the pandemic. However, in other regions, such as the euro area, activity was weaker than expected.

— On data to February, recent PMI indicators reflect some stabilisation of global economic activity, including in manufacturing, which already appears to have moved out of contractionary territory in the United States and China (see Chart 1.a).

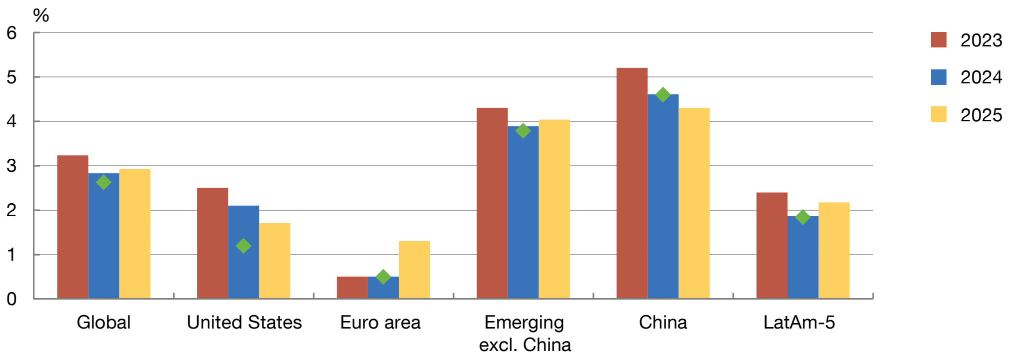
— The global growth outlook for 2024 has been revised slightly upwards in recent months, mainly owing to the United States (see Chart 1.b). In any event, relatively moderate global GDP growth rates (in historical terms) are envisaged for 2024 and 2025, with a gradual slowdown in the momentum of activity projected in the United States and China.

Chart 1

1.a PMIs



1.b Consensus growth forecasts (a)



SOURCES: S&P Global and Consensus Forecast.

a The February 2024 forecasts (bars) are compared with the December forecasts (diamonds). "Emerging excl. China" includes India, Indonesia, Malaysia, Philippines, Thailand, Bulgaria, Hungary, Poland, Romania, Russia, Türkiye and Ukraine. "LatAm-5" includes Mexico, Colombia, Peru, Chile and Brazil. Lastly, "Global" includes all the foregoing plus the United States, China and the euro area.

2 The global disinflation process continues, even at a somewhat faster pace than forecast in certain regions

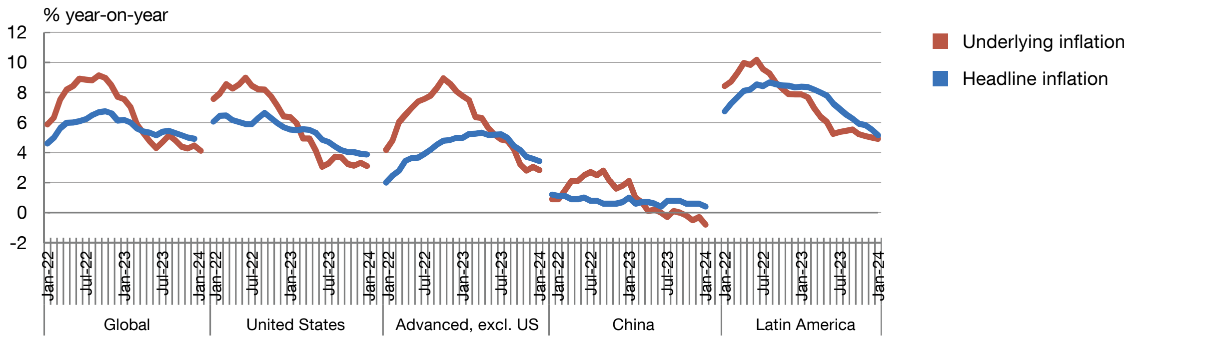
— In general, inflation rates (both headline and underlying) have continued to moderate in recent months in the main world economies (see Chart 2.a).

— In a setting of restrictive monetary policies, this disinflation process has also been influenced by the fall in energy prices – particularly sharp in the case of natural gas (see Chart 2.b) – and the absence, for the time being, of significant second-round effects. This has led to medium-term inflation expectations remaining anchored around the monetary policy targets of the world's main central banks.

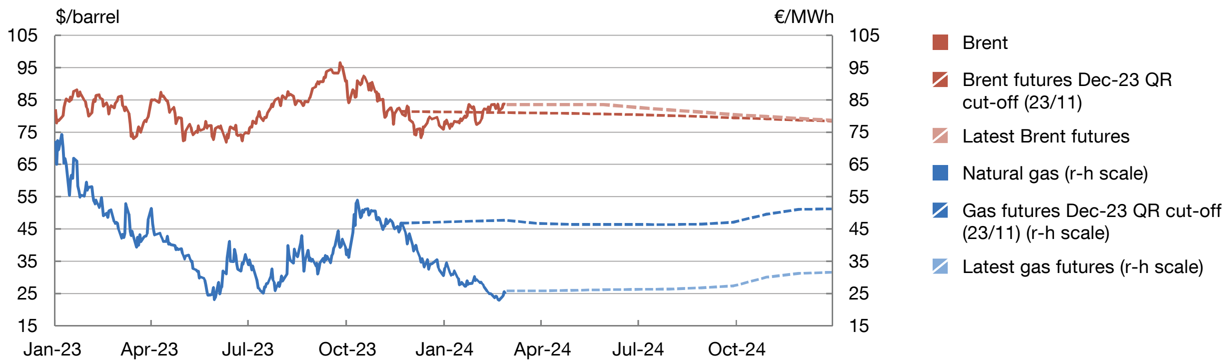
— Looking forward, inflation is expected to continue to decline over the coming quarters, albeit at a slightly more moderate pace than in 2023, especially in the advanced economies. Nevertheless, these expectations largely depend on profit margins and wages remaining relatively contained and on no further deterioration in the global geopolitical situation that could lead to fresh global trade disruptions and energy commodity price rises.

Chart 2

2.a Inflation



2.b Oil and gas prices and futures



SOURCES: National statistics and Refinitiv.

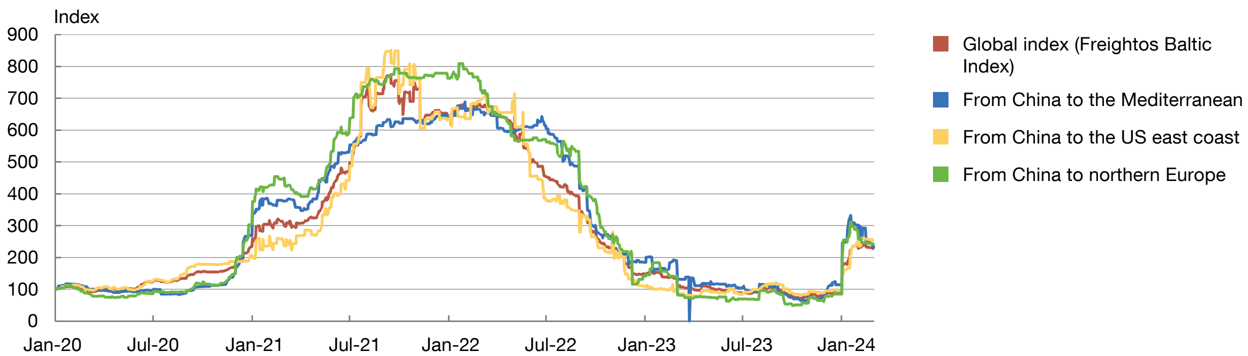
3 The geopolitical tensions in the Red Sea have led to a sharp increase in transport costs, although their impact on global supply chains remains muted

— Since mid-December, as a result of the Houthi rebels' attacks on container ships passing through the Red Sea on their way to the Suez Canal, major shipping companies are rerouting much of this traffic via the Cape of Good Hope, significantly increasing transit times and shipping costs (see Chart 3.a).

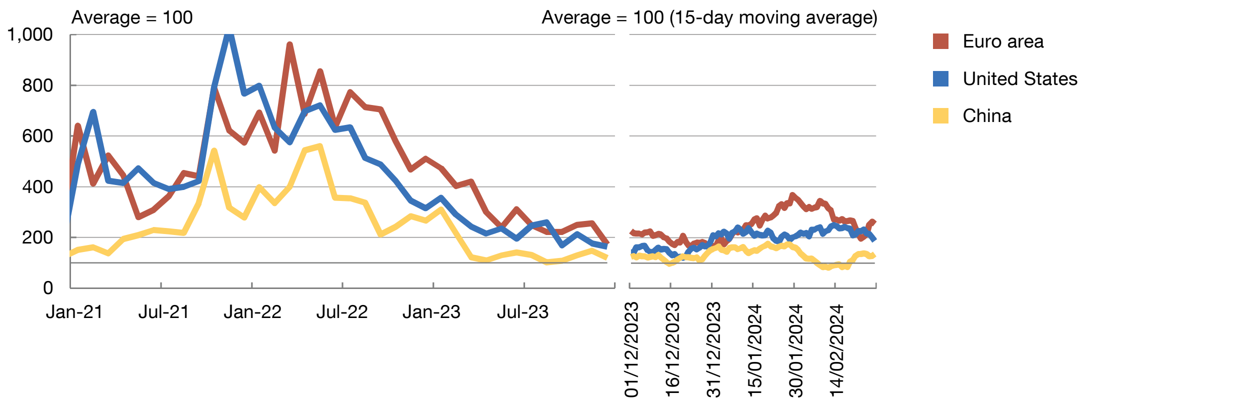
— In any event, the current shock, which causes delays but no interruption of maritime traffic, arises amid the absence of congestion in logistics industries and global supply chains, thus limiting the impact on them so far. The bottleneck indices available point in this direction[1] (see Chart 3.b). In particular, according to these indicators, the impact appears to be somewhat greater in the euro area, although the index for this region is still very distant from the highs observed during the pandemic.

Chart 3

3.a Maritime transport cost indicators



3.b Supply bottlenecks index (monthly and daily)



SOURCES: Refinitiv and Banco de España. Latest observation: 1 March 2024.

1 See Pablo Burriel, Iván Kataryniuk, Carlos Moreno Pérez and Francesca Viani (2024). "A new supply bottlenecks index based on newspaper data". *International Journal of Central Banking.* Forthcoming.

4 The central banks of the main advanced economies keep their interest rates unchanged

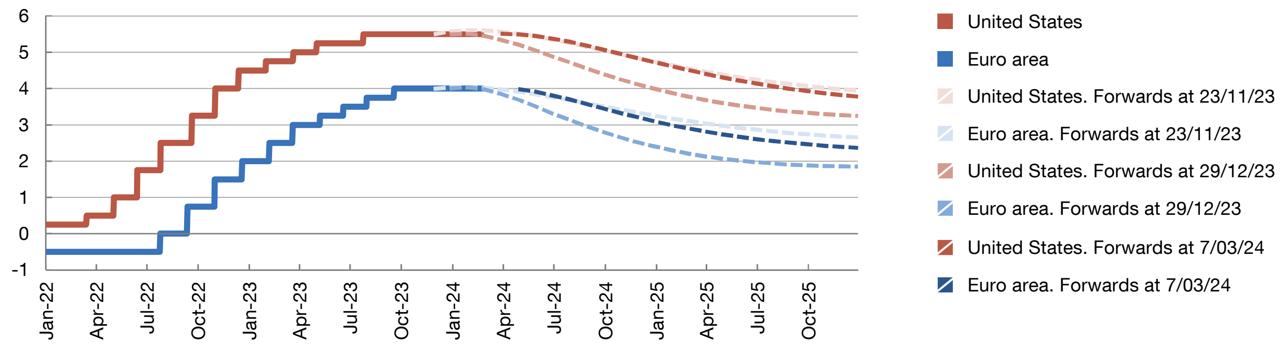
— Monetary policies are at different phases of the tightening cycle. In emerging market economies central banks have continued to cut their policy rates, a process which began in 2023 H2, albeit with varying intensity.

— By contrast, in the main advanced economies central banks have kept their policy rates unchanged, highlighting that there is no fixed timetable for rate cuts and that future decisions will continue to be data-dependent and follow a meeting-by-meeting approach.

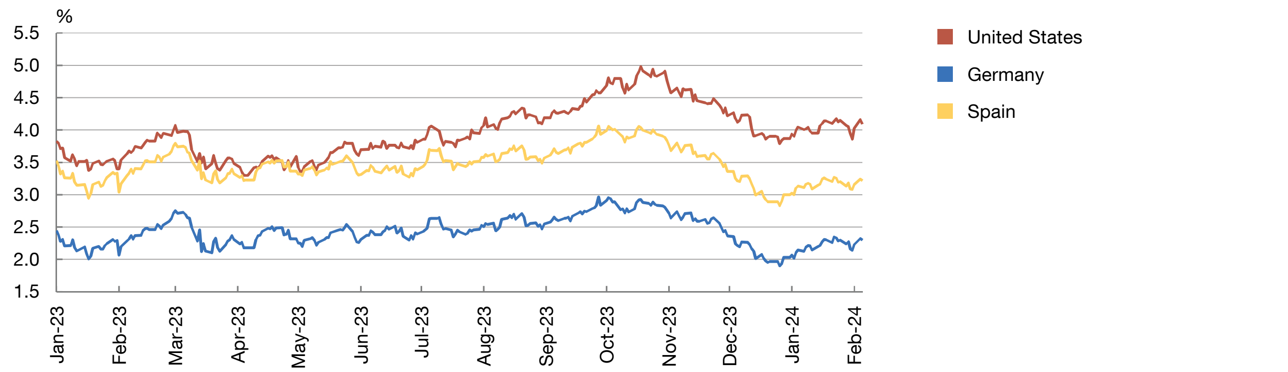
— Both in the United States and in the euro area, the expectations about the future path of policy rates have been revised upwards since end-2023, returning to figures similar to, although still somewhat lower than, those as at the cut-off date for the Banco de España's December forecasting exercise (see Chart 4.a).[2] Accordingly, long-term interest rates have also generally risen in Q1 (see Chart 4.b), although euro area sovereign risk premia have declined.

Chart 4

4.a Policy interest rates observed and forwards (a)



4.b 10-year sovereign debt yields



SOURCES: Refinitiv Datastream, Bloomberg Data License and Banco de España.

a Instantaneous forwards estimated based on market data on OIS rates at different maturities using the Svensson parametric model (Lars E. O. Svensson (1994). "Estimating and Interpreting Forward Interest Rates: Sweden 1992-1994". IMF Working Papers, 94/114, International Monetary Fund) and adding the spread between the policy rate and the overnight interest rate at the estimation date.

2 The cut-off date for the Banco de España's March projections exercise was 15 February, when the interest rate assumptions were slightly lower than those at the cut-off date of this report.

5 Stock market prices have risen and risk premia have remained low despite the recent interest rate hikes

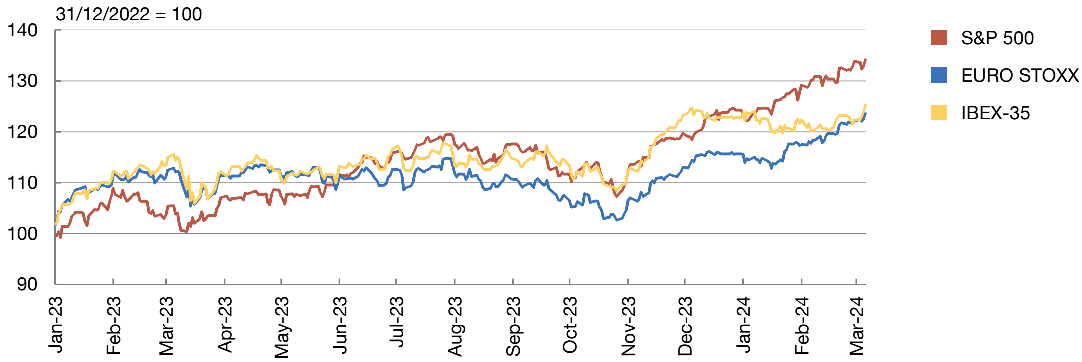
— Positive macroeconomic surprises and good corporate earnings, especially in the United States, have prompted strong stock market gains internationally in the quarter, prolonging the upward trend of late 2023 (see Chart 5.a). Gains have been particularly noteworthy in the artificial intelligence sector. Despite the increase observed in long-term interest rates in the year to date, some indices, such as the S&P 500 and the EURO STOXX, have posted record highs.

— The IBEX-35, however, has risen more moderately, in part influenced by the lack of tech stocks in the index and the unfavourable performance of certain sectors, such as the electricity and real estate sectors.

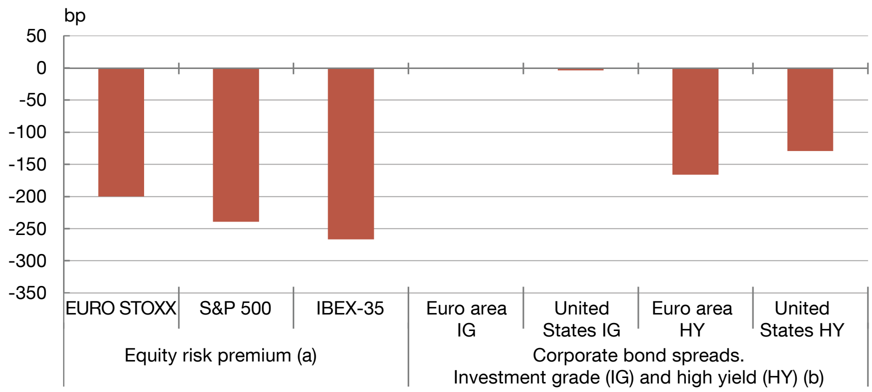
— Risk premia in the high-yield fixed-income segment and equities have remained at very low levels from a historical viewpoint, despite the fact that the macro-financial scenario remains complicated and is still affected by substantial geopolitical tensions (see Chart 5.b).

Chart 5

5.a Stock markets



5.b Risk premia. Deviation from the historical average



SOURCES: Refinitiv Datastream, Bloomberg Data License and Banco de España.

a 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). Data as at 29/02/2024. The historical average, which refers to the period 2006-2024, is 659 bp for the EURO STOXX, 495 bp for the S&P 500 and 782 bp for the IBEX-35.

b Spreads over the swap curve of the ICE Bank of America Merrill Lynch indices. Data as at 7/03/2024. The historical average, which refers to the period 1998-2024, is 78 bp in the euro area and 131 bp in the United States for IG bonds, and 452 bp in the euro area and 445 bp in the United States for HY bonds.

6 Economic activity in the euro area remains sluggish, with modest growth forecasts in the short and medium term

— Economic activity in the euro area stalled in 2023 Q4, following a slight downturn in the previous quarter. GDP is estimated to have grown by 0.5% in 2023 as a whole, well below the 3.4% growth observed in 2022. Factors contributing to this lacklustre performance include tight financial conditions, deteriorating confidence and euro area countries' loss of global market share.

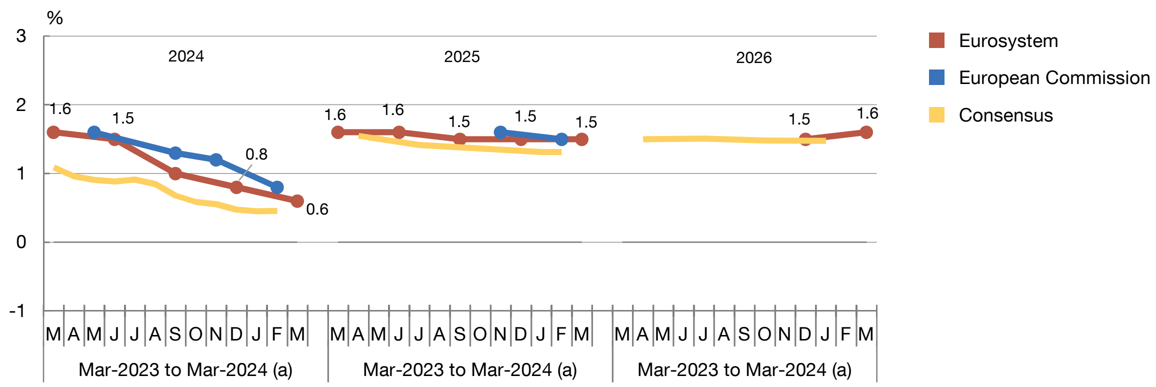
— Activity remained weak in early 2024, according to the most recent short-term indicators, which have performed worse than expected. However, these indicators, based on their forward-looking components, suggest a mild pick-up in economic activity. All this against a backdrop in which the labour market remains notably resilient and the unemployment rate holds stable at all-time lows, despite the fact that job creation has lost some momentum in the most recent period.

— In this setting, the March 2024 European Central Bank (ECB) staff macroeconomic projection exercise continues to point to a scenario of gradual, albeit weaker than expected, economic recovery in the euro area throughout the year, with GDP growth of 0.6% in 2024, 0.2 pp down on the level envisaged in the December 2023 exercise. For 2025 and 2026, the growth rate is expected to remain virtually unchanged at 1.5% and 1.6%, respectively (see Chart 6.a).

— The recovery in activity appears to rely above all on an improvement in households' real income, buoyed by the ongoing fall in inflation — in an environment of lower energy prices — and the forecast wage increases.

Chart 6

6.a Euro area GDP growth forecasts



SOURCES: European Commission, Consensus Economics and Eurosystem.

a The letters refer to the month in which the corresponding forecast was published.

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7 Euro area inflation has surprised on the downside in recent months

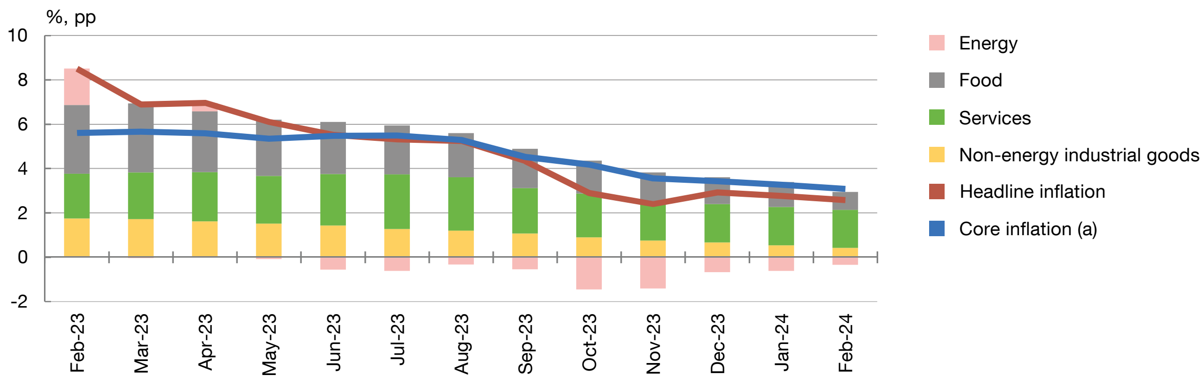
- According to the flash estimate of the Harmonised Index of Consumer Prices (HICP), headline inflation in the euro area surprised again on the downside in February, standing at 2.6%, partly due to the stronger-than-expected decline in the energy component (see Chart 7.a).

- Core inflation fell by 0.2 pp in February to 3.1%, firmly establishing the downward path that began in 2023 Q3. This decline was mainly attributable to the fall in the prices of non-energy industrial goods. Conversely, the contribution from services prices – more affected by the rise in labour costs – remains high.

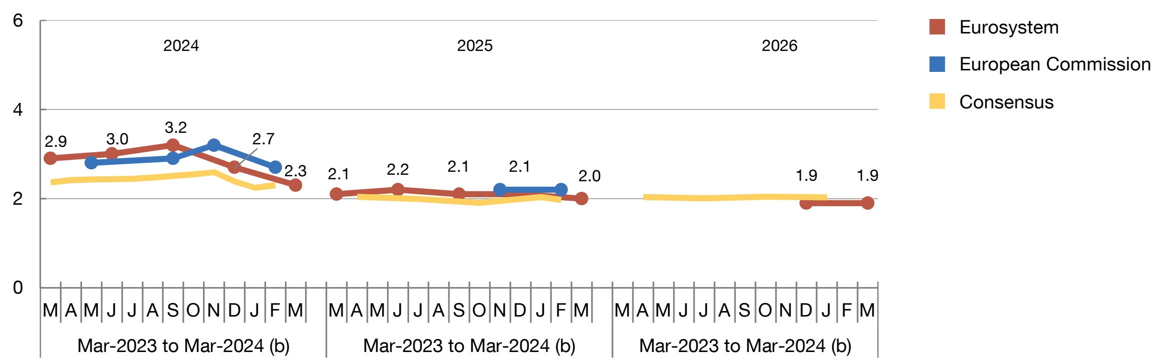
- In line with the recent favourable inflation data and the new assumptions (of lower future energy prices), the March ECB staff macroeconomic projection exercise revised the inflation outlook for 2024 and 2025 down from the December exercise, by 0.4 pp (to 2.3%) and 0.1 pp (to 2%), respectively. For 2026, inflation is expected to remain at 1.9% (see Chart 7.b).

Chart 7

7.a Euro area inflation and contribution of components



7.b Euro area inflation forecasts



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

a Headline HICP excluding energy and food.
b The letters refer to the month in which the corresponding forecast was published.

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8 The ECB keeps its policy rates unchanged at restrictive levels

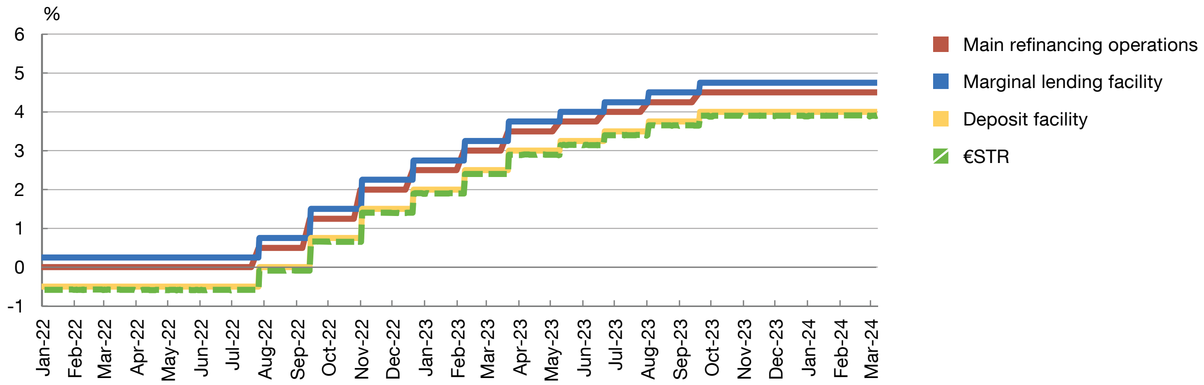
— At its March meeting the ECB Governing Council has, for the fourth consecutive time, decided to keep its three key interest rates unchanged (see Chart 8.a). The deposit facility rate has stood at 4% since September 2023.

— The decision was taken in light of the incoming economic and financial data and the latest ECB staff projections. Although headline inflation and most measures of underlying inflation have continued to ease across the euro area, domestic price pressures remain high, in part owing to strong growth in wages. Accordingly, the Governing Council considers that the key ECB interest rates are at levels that, maintained for a sufficiently long duration, will help to ensure that inflation soon reaches its medium-term target of 2%. In any event, the Governing Council will continue to follow a data-dependent approach to determining the appropriate level and duration of restriction.

— The process of normalisation of the Eurosystem's balance sheet continues. The portfolio of assets purchased under the asset purchase programme (APP) continues to decline at a measured and predictable pace, as since July 2023 the Eurosystem no longer reinvests the principal payments from maturing securities.

Chart 8

8.a Key ECB interest rates and €STR



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SOURCES: Banco de España and Refinitiv Datastream. Latest data observed: 07/03/2024.

9 In Spain, economic growth unexpectedly picked up speed in 2023 Q4

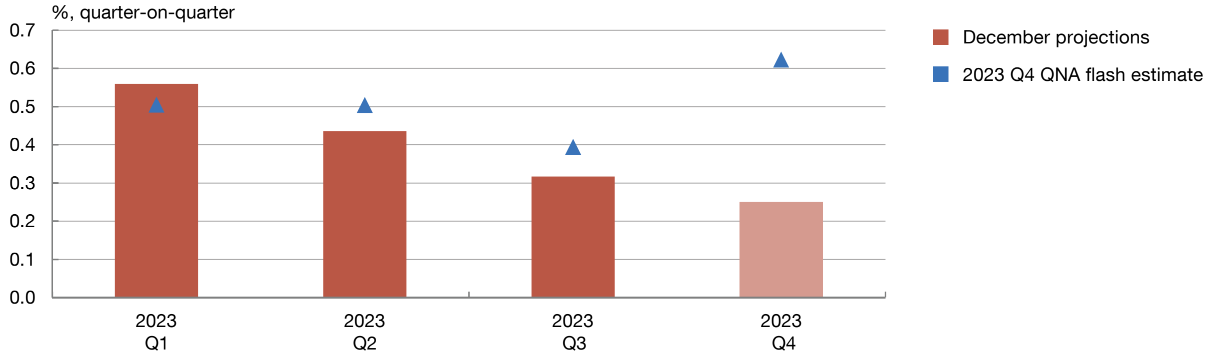
— According to the Quarterly National Accounts (QNA) flash estimate,[3] GDP grew by 0.6% in 2023 Q4, 0.3 pp more than envisaged in the Banco de España projection exercise published in December (see Chart 9.a). As per this estimate, the National Statistics Institute (INE) also revised GDP growth slightly upwards in 2023 Q2 and 2023 Q3. These figures point to output growth of 2.5% in 2023 as a whole, in contrast to the 5.8% observed in 2022.

— GDP growth in Q4 was once again driven by domestic demand, with a notable contribution from government consumption and stockbuilding (see Chart 9.b). Conversely, the contribution from private consumption and gross fixed capital formation surprised on the downside. Net external demand made a somewhat positive contribution to GDP growth, thanks to the greater relative momentum of exports.

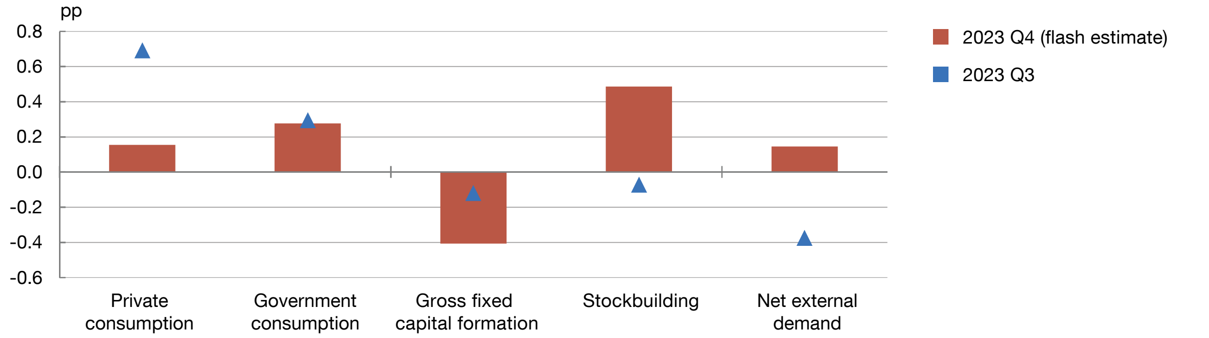
— From the supply perspective, agriculture, industry and construction made a higher contribution to growth in Q4 – following the weak performance of previous quarters – while activity slowed in the services sectors.

Chart 9

9.a GDP growth in Spain



9.b Contributions to GDP growth in Spain



SOURCES: INE and Banco de España.

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3 The information provided by the QNA for 2023 Q4 is still preliminary and thus subject to review.

10 The latest short-term economic indicators suggest that economic growth in Spain may have decelerated slightly in 2024 Q1

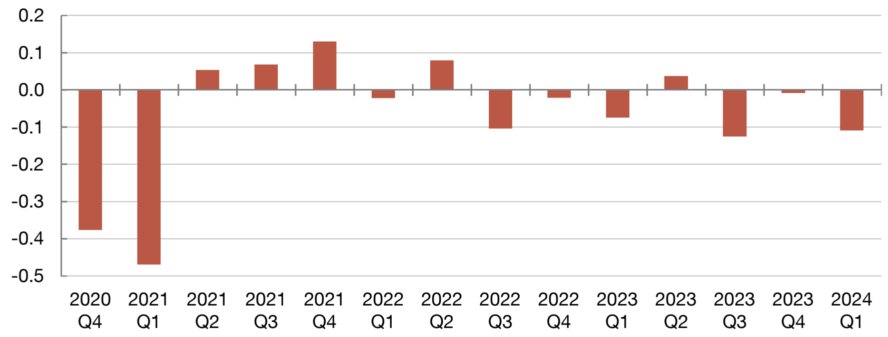
— An overall analysis of the various indicators (including employment, consumption and confidence indicators) that provide partial, and as yet incomplete, information on the performance of economic activity in 2024 Q1 suggests that Spanish GDP could grow in this period by 0.4% quarter-on-quarter. There is, however, considerable uncertainty surrounding this estimate.[4]

— Among the available indicators, the results of the Banco de España Business Activity Survey (EBAE, by its Spanish acronym) suggest that firms' turnover declined in aggregate terms in Q1 as a whole compared with the previous quarter (see Chart 10.a), albeit with notable sectoral heterogeneity.[5]

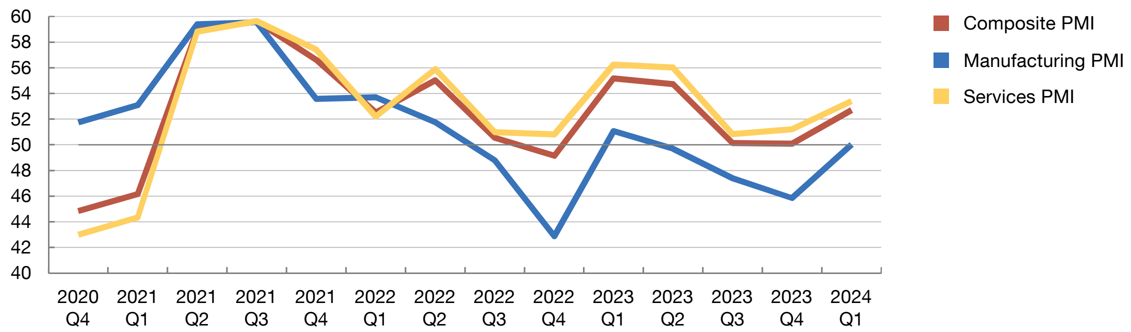
— On information up to February, the PMIs rose above the levels observed at end-2023, in particular, manufacturing PMIs, which had been in contractionary territory (below the 50 mark) since 2023 Q2 (see Chart 10.b).

Chart 10

10.a Quarterly change in EBAE turnover (a)



10.b PMIs (b)



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

a The qualitative responses from the EBAE are converted into a numerical scale as follows: significant decrease = –2; slight decrease= – 1; stability = 0; slight increase = 1; significant increase = 2.
b The 2024 Q1 PMI figure is the average in January and February.

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

5 For more details, see Fernández and Izquierdo. (2024).

11 Job creation remains strong, buoyed, as in previous quarters, by the strength of employment among foreign nationals

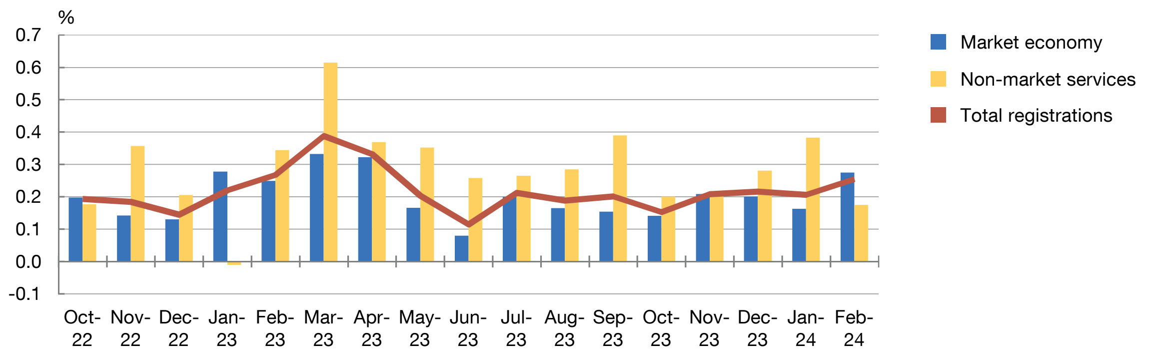
— In February, social security registrations rose by 0.3% in seasonally adjusted terms, a slightly higher rate than that observed since summer 2023 (see Chart 11.a). By activity, there was notable employment growth in the market economy, particularly in the agricultural and market services sectors (especially in hospitality).

— In 2023 as a whole, the contribution of foreign national workers provided a strong boost to social security registrations, which grew by 9.5% on average in this group, compared with 1.7% for Spanish nationals. This pattern continued into early 2024, with year-on-year growth in February of 8.3% and 1.9% in the social security registrations of foreign and Spanish nationals, respectively.

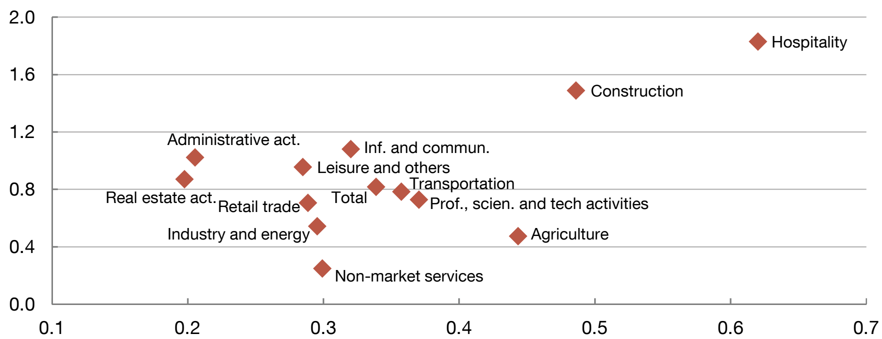
— In recent quarters, the strength of employment among foreign nationals appears to have contributed to easing the labour market tightness in some sectors, such as hospitality and construction, where firms report more severe labour shortages (see Chart 11.b). Indeed, these two sectors, the hardest hit by labour shortages (according to the EBAE), saw the highest relative increase in the number of foreign national workers in 2023.

Chart 11

11.a Total social security registrations in the market economy and non-market services sectors (a)



11.b Relationship between growth in registrations of foreign nationals and perceived labour shortages (b)



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

a Seasonally adjusted monthly rate.
b The vertical axis shows the change in weight of social security registrations of foreign nationals in total social security registrations in each sector between 2022 and 2023. The horizontal axis represents the indicator of labour shortages reported in 2022 Q4 by firms participating in the EBAE.

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12 Financing to households and firms remains weak, against a backdrop of high financing costs

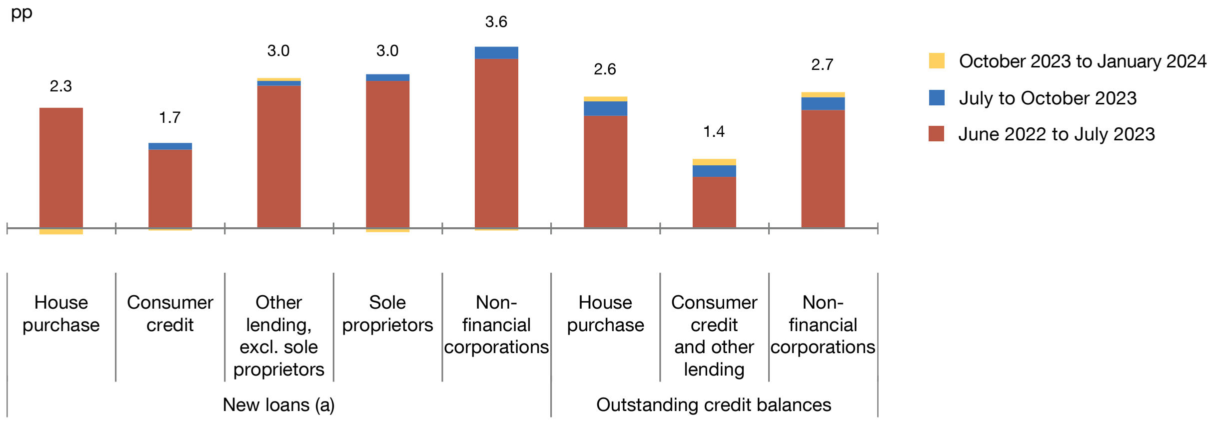
— As the ECB monetary tightening cycle has peaked, interest rates on new lending to households and firms have started to decline somewhat, while the average cost of outstanding credit is still rising, albeit very slightly (see Chart 12.a).

— According to the Bank Lending Survey (BLS), in 2023 Q4 demand for credit contracted and credit standards tightened only for consumer credit and other lending to households, although to a lesser extent than in Q3. Financial institutions expect credit demand and supply dynamics to be very similar in 2024 Q1.

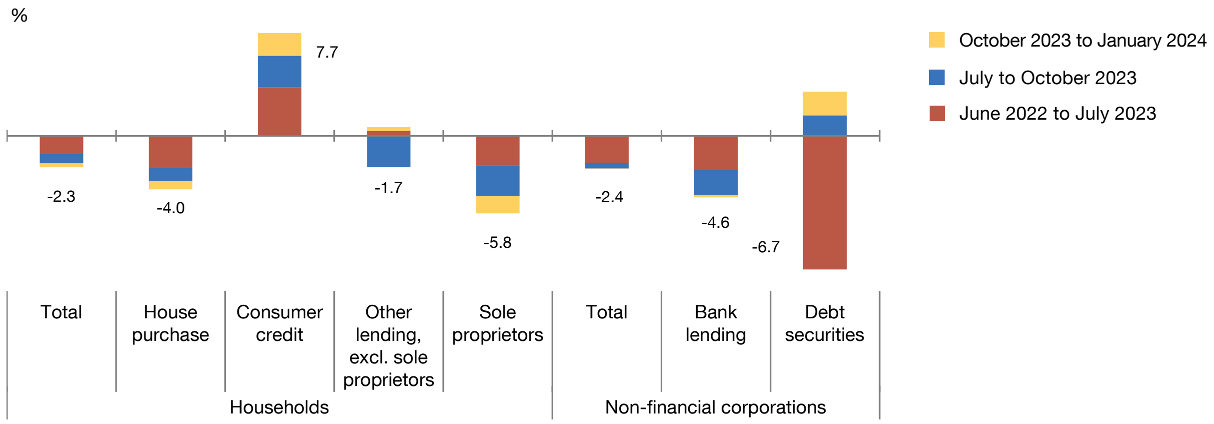
— Financing to households and firms has continued to contract, albeit at a declining pace (see Chart 12.b). However, consumer credit and corporate bond issuance have recorded positive financing flows in recent quarters.

Chart 12

12.a Increase in the cost of credit since the start of the monetary policy tightening cycle



12.b Change in financing to households and firms since mid-2022 (b)



SOURCE: Banco de España.

a Bank interest rates are narrowly defined effective rates (NDERs), i.e. they exclude related charges, such as repayment insurance premia and fees, and are adjusted seasonally and for the irregular component.
b Seasonally adjusted data. Includes securitisations except in the breakdown of other lending. The total includes the rest of the world. Debt securities include issues of subsidiaries abroad.

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13 Private consumption in 2024 Q1 maintains the previous quarter's momentum

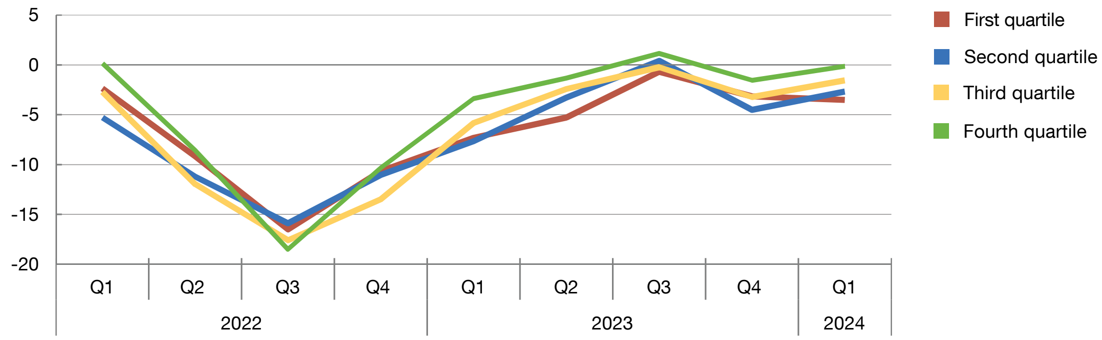
— After a stronger-than-expected slowdown in the final months of 2023, private consumption appears to be growing at a rate similar to that of 2023 Q4. This growth would be underpinned, among other factors, by the still strong labour market, the high initial saving rate and the gradual improvement in consumer confidence, particularly in the middle and high-income brackets (see Chart 13.a).

— In any event, recent developments in consumer credit and car sales (see Chart 13.b) suggest that the boost to consumption from household spending on durable goods is waning, as already anticipated in the Banco de España's December projection exercise.

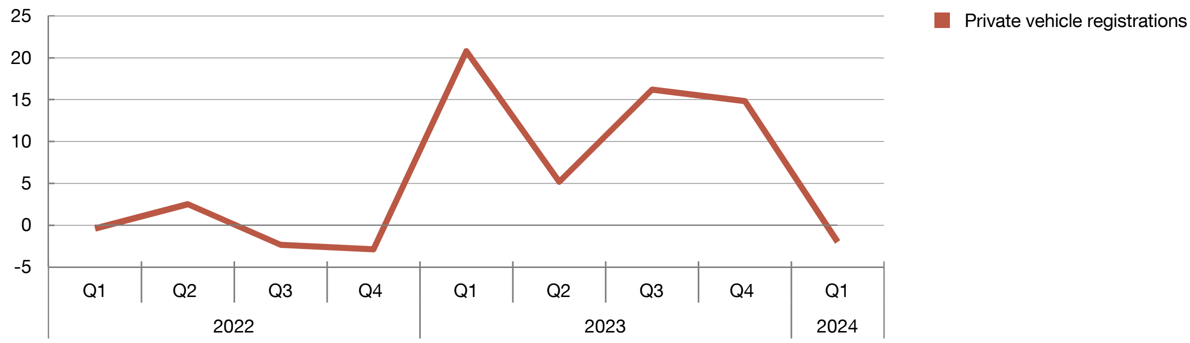
— Looking ahead to the coming quarters, in a setting of gradual moderation of inflationary pressures, a relatively strong labour market and somewhat more favourable financing conditions, household spending is expected to continue on an upward trend, with this demand component growing at a slightly higher rate in 2024 as a whole than in 2023 (1.8%).

Chart 13

13.a Consumer confidence (normalised data). Breakdown by income quartile (a)



13.b Private vehicle registrations (b)



SOURCE: European Commission and ANFAC.

a The figure for 2024 Q1 is the average of January and February (the latest data available). Normalised data, obtained by subtracting from the indicator its average value since 2000.
b Year-on-year annual growth rates. The figure for 2024 Q1 is calculated based on the information for January and February, with respect to 2023 Q1.

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14 Weakness in business investment could continue into early 2024, while residential investment appears to be moving at a more favourable pace

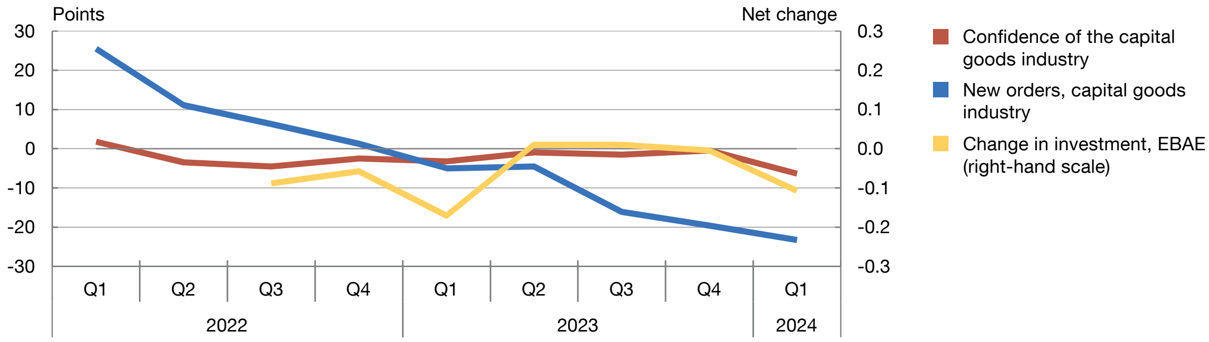
— In 2023 Q4 gross fixed capital formation performed worse than expected, falling by 2% quarter-on-quarter. This decline, which was greater than that seen in Q3 (0.7%), was fairly broad-based, with a notable drop in investment in machinery and equipment (4.8%).

— The succession of negative surprises in this demand component over the last few quarters may reflect a greater structural weakness of business investment than that considered a few months ago. This, together with recent developments in various qualitative indicators (see Chart 14.a), would point to a certain fragility in business investment in early 2024.

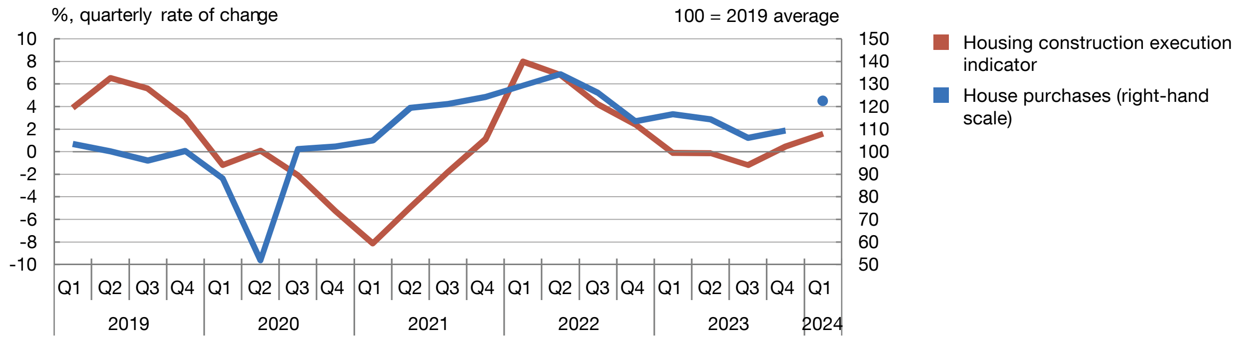
— Meanwhile, residential investment, which grew 0.2% at end-2023, is likely to remain positive in Q1 this year, in the light of the recent performance of the housing construction execution indicator (see Chart 14.b). All this in a setting of rising house prices (from 4.2% year-on-year at end-2023), mainly due to insufficient supply to meet demand.[6]

Chart 14

14.a Qualitative indicators of investment (a)



14.b Changes in the main residential investment indicators (b)



SOURCES: European Commission, EBAE (Banco de España), Centro de Información Estadística del Notariado, INE and Ministerio de Transportes y Movilidad Sostenible.

a The latest available observation for confidence and new industrial orders is February 2024. The qualitative responses from the EBAE are converted into a numerical scale as follows: significant decrease = -2; slight decrease = -1; stability = 0; slight increase = 1; significant increase = 2.

b For the housing construction execution indicator, the time frame considered is three months from issuance of the building permit to the construction start date and 18 months for the construction work. Seasonally adjusted series for house purchases. Latest observation: January 2024.

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6 See Lajer, Andrés, 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.

15 In 2024 Q1 the external sector remains on the positive trend of end-2023, in both the goods and the services component

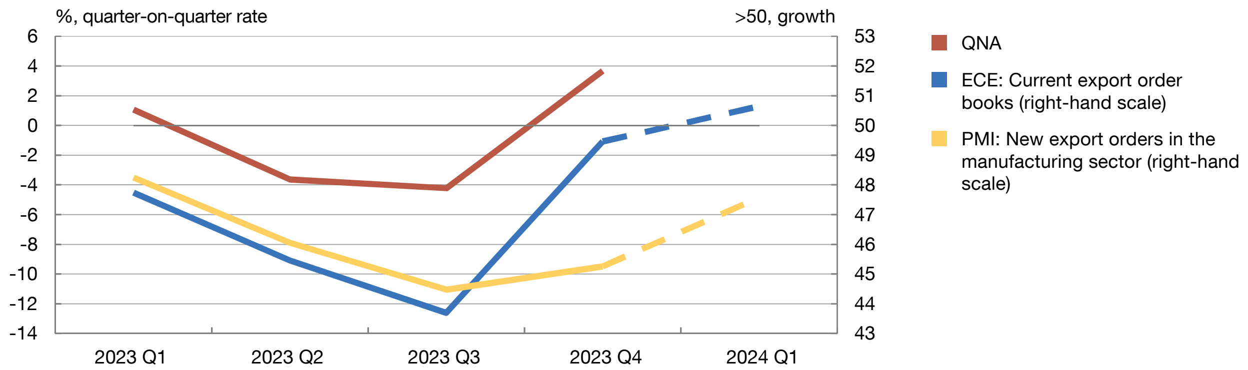
— The positive contribution of net external demand to growth in 2023 Q4 (0.1 pp) was driven by the marked improvement in exports (especially goods exports, which grew by 3.7%). In the light of recent developments in export order books and the PMI indicator of new export orders (see Chart 15.a), this favourable performance of goods exports appears to continue also in the first quarter of the year. Goods imports, for their part, seem to remain somewhat weighed down by the relative sluggishness expected in business investment.

— In any event, net goods exports in the coming months could be highly conditioned by the geopolitical tensions in the Red Sea and a possible escalation of protests in the European agricultural sector.

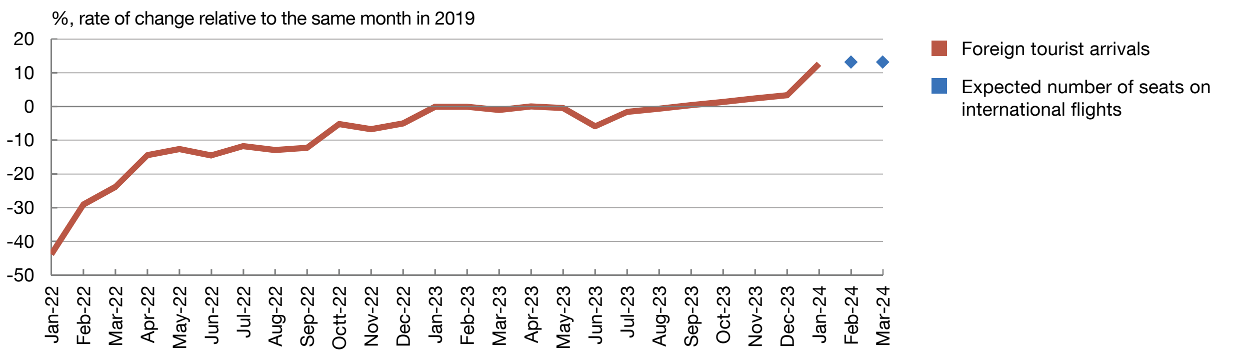
— Meanwhile, both non-travel services exports and tourism exports grew in 2023 Q4. As regards the latter, the latest indicators of international passenger arrivals are consistent with this positive course continuing in 2024 Q1 (see Chart 15.b).

Chart 15

15.a Volume of goods exports (a)



15.b International air passenger arrivals. Rates of change relative to pre-pandemic levels



SOURCES: INE, Ministerio de Economía, Comercio y Empresa, S&P Global and Aena.

a The data for 2024 Q1 are the average of January and February.

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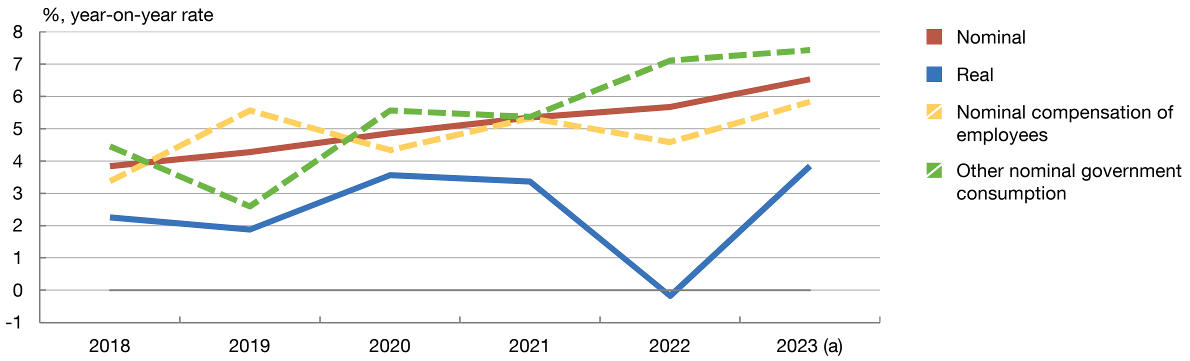
16 Government consumption surprised on the upside in 2023

— The flash QNA data for Q4 and the revision of previous quarters' data were a considerable upward surprise in terms of the behaviour of government consumption. Thus, in the year as a whole, this item would have increased by 3.8% in real terms (compared with the 2.2% forecast in the Banco de España's December projection exercise), a much higher rate than in 2022 and also higher than during the worst of the pandemic (see Chart 16.a). This acceleration, which is also evident in nominal terms, would be attributable to both employee compensation and other government consumption items.

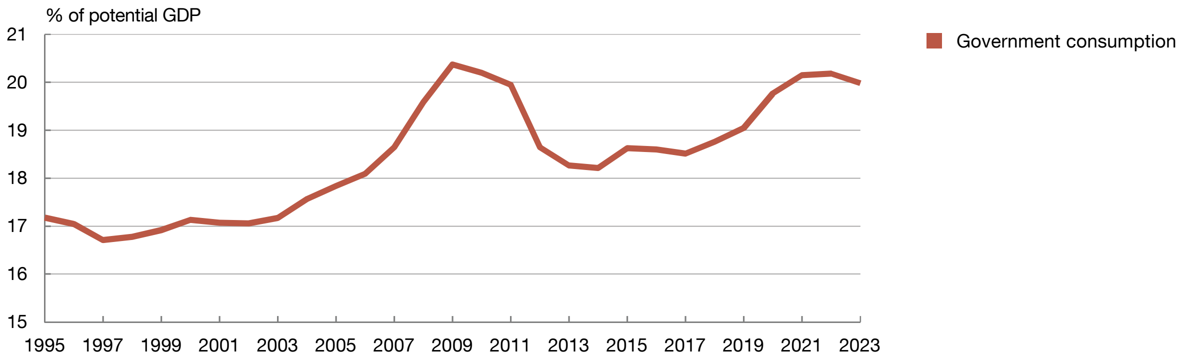
— Thus, as a percentage of potential GDP, government consumption would now stand at a level close to the 2009 all-time high (see Chart 16.b). Insofar as recent developments in this item – whose determinants are shrouded in considerable uncertainty – do not stem from transitory factors (such as possible NGEU-related spending and other temporary measures), this increased government consumption will put further pressure on public finances, underlining the need for Spain to embark on a rigorous fiscal consolidation process.[7]

Chart16

16.a Recent developments in government consumption



16.b Government consumption over the long term



SOURCES: Banco de España, INE and IGAE.

a For 2023, the breakdown of government consumption into employee compensation and other consumption is based on monthly data to November for the aggregate excluding local government.

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7 See the Foreword by the Governor in the Banco de España Annual Report 2022.

17 The partial extension into 2024 of the support measures introduced to cushion the impact of inflation could entail the need for compensatory fiscal adjustment measures

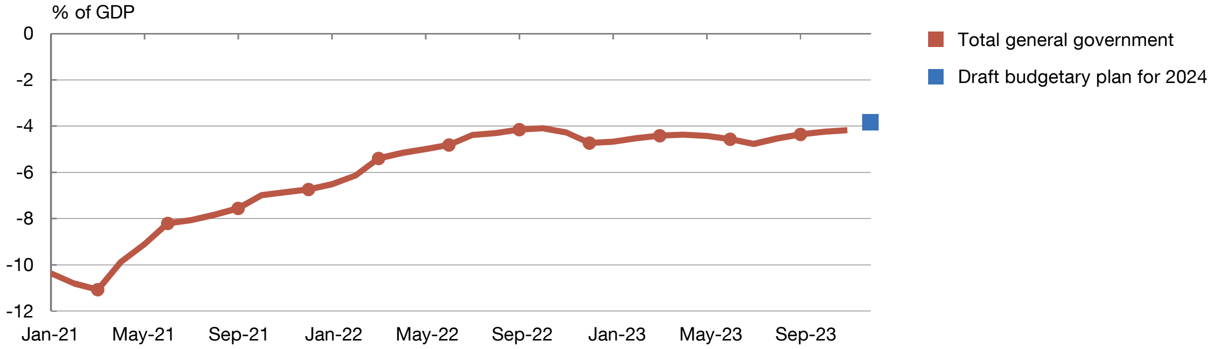
— To November 2023, in cumulative 12-month terms, the Spanish general government balance recorded a deficit equivalent to 4.2% of GDP. This imbalance stands almost mid-way between the 2022 figure (4.7% of GDP) and the Government's deficit target for 2023 (3.9% of GDP) (see Chart 17.a).

— The decline in the deficit in 2023 was due to high revenue growth (8.5% to November) that exceeded expenditure growth (6.5%). The main revenue drivers were the higher direct tax bases resulting from the nominal increases in corporate profits, wages and social benefits. Expenditure growth was driven by the revaluation of pensions and strong government consumption, but the impact was partly offset by the lower cost, compared with 2022, of the support measures introduced in response to the inflationary crisis.

— For 2024, the Government has partially extended some of these support measures, such as the lower VAT rate on food, lower energy taxes and the public transport subsidies.[8] Overall, this extension is expected to have a budgetary cost of around 0.6 pp of GDP in 2024. This is less than the cost of these measures in 2023 (1.2 pp of GDP) and in 2022 (1.5 pp of GDP). However, to meet the European recommendation for 2024 – that nominal growth of net nationally financed primary expenditure in 2024 should not exceed 2.6% – it may be necessary to implement further compensatory measures to cut spending or raise revenue.

Chart 17

17.a General government balance (a)



SOURCES: Banco de España and IGAE.

a The dots denote the data for the overall general government sector, which the National Audit Office (IGAE) only publishes on a quarterly basis and with a longer time lag. The remaining monthly data are extrapolated drawing on the aggregate excluding local government.

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8 Royal-Decree Law 8/2023 of 27 December 2023.

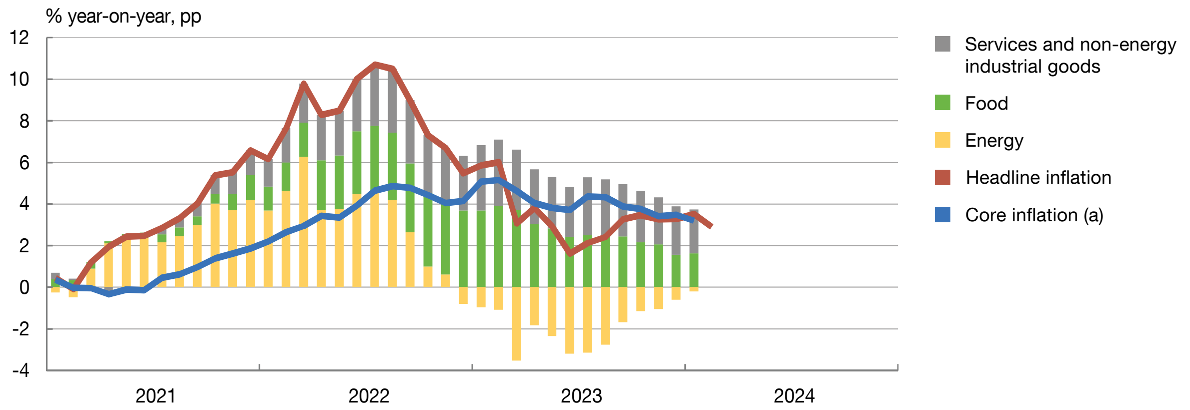
18 Inflation fell to 2.9% in February, after climbing in January following partial withdrawal of the support measures introduced in response to the energy crisis

— Inflation fell by 0.6 pp in February,[9] taking the year-on-year rate of HICP to 2.9% (see Chart 18.a), essentially as a result of the favourable performance of electricity prices in the month. The increase in inflation in January was mainly due to the partial withdrawal of the support measures introduced in response to the energy crisis. This affected electricity and gas prices[10] and is estimated to have added around 0.3 pp to the January headline inflation rate.

— On data to January, the slowdown in food prices came to a halt in early 2024, mainly owing to the base effect of the VAT rate cut at the start of 2023.[11] Meanwhile, core inflation continued to decline, reaching a year-on-year rate of 3.2%, almost 2 pp below the figure recorded a year earlier. By component, the slowdown seen in previous months in non-energy industrial goods continued, although the seasonal sales had a smaller than expected impact on clothing and footwear. The moderation in leisure, food services and tourism and in housing maintenance and repair underpinned a minor slowdown in the services component.

Chart 18

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



SOURCES: Eurostat and Banco de España.

a Headline inflation, excluding energy and food.

9 According to the February headline HICP flash estimate. The disaggregated HICP data for February will be published on 14 March.

10 Although the measures approved in late December entailed a partial renewal of the support measures introduced in response to the surge in inflation, they did lead to increases in some tax rates. Thus, in January, the VAT rate on electricity and natural gas rose from 5% to 10% and the excise duty on electricity from 0.5% to 2.5%. As wholesale electricity prices dropped below €45/MWh in February, the VAT rate on electricity went back to 21% in March. In view of electricity prices on the futures markets, the VAT rate is expected to be at that level for four months in 2024.

11 In January the number of headings recording lower year-on-year growth fell to 54% of the food basket, compared with 90% in December. This is explained, in part, by the base effect of the cut in the VAT rate on certain essential food items introduced in January 2023.

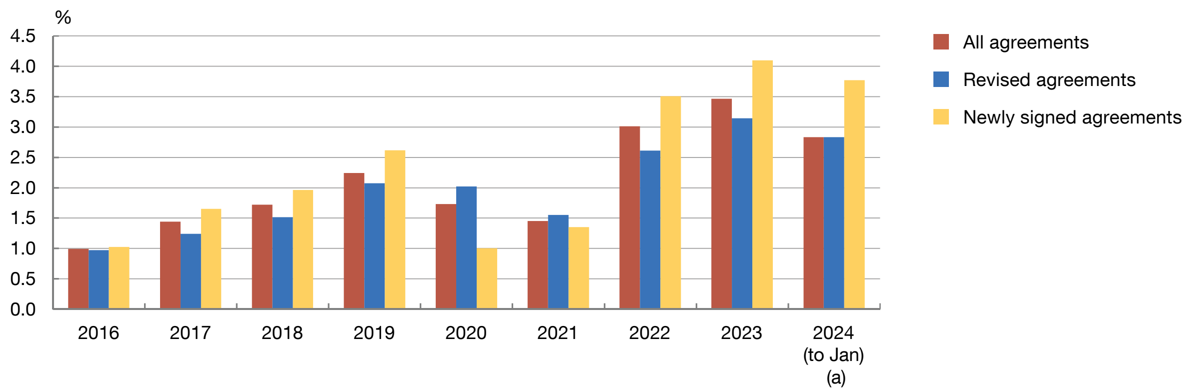
19 The negotiated wage increase for 2024 stands at 2.8%, in line with the fifth Employment and Collective Bargaining Agreement, but labour costs are rising at a faster pace

— On data to January, the negotiated wage settlement for 2024 is 2.8%. This is in line with the increase envisaged in the fifth Employment and Collective Bargaining Agreement[12] (AENC, by its Spanish acronym) and entails a decline of 0.7 pp in the rate of growth of negotiated wages compared with 2023 (see Chart 19.a). Almost all of the 7.3 million wage-earners with an agreement in force for 2024 had wage agreements in previous years.

— Compensation per employee in the market economy rose by 6% in 2023, outpacing the negotiated wage increases. According to the quarterly labour costs survey, with data to Q3, the reasons for this stronger growth appear to be the rise in non-wage costs – mainly owing to the higher social contributions[13] – and an increase in ordinary wage costs in excess of the negotiated wage increase.

Chart 19

19.a Wage settlements



SOURCES: Ministerio de Trabajo y Economía Social and INE.

a The newly signed agreements in January 2024 are not representative (just eight wage agreements covering only 16,453 workers).

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12 In the agreements signed in 2024, the wage increase agreed is 3.8% (above the benchmark set in the fifth AENC). But this only affects around 16,000 workers and cannot be considered representative of wage bargaining for the year. Taking into account the agreements with effect in 2024 signed in the second half of 2023, after the fifth AENC was signed in May, the average wage increase stands at 2.9%, in line with the 3% benchmark agreed.

13 Especially as a result of the rise in the maximum contribution bases (8.6%) and the minimum contribution bases (8%, following the increase in the national minimum wage), and the 0.6 pp hike in the social security contribution rate as a consequence of the entry into force of the intergenerational equity mechanism.

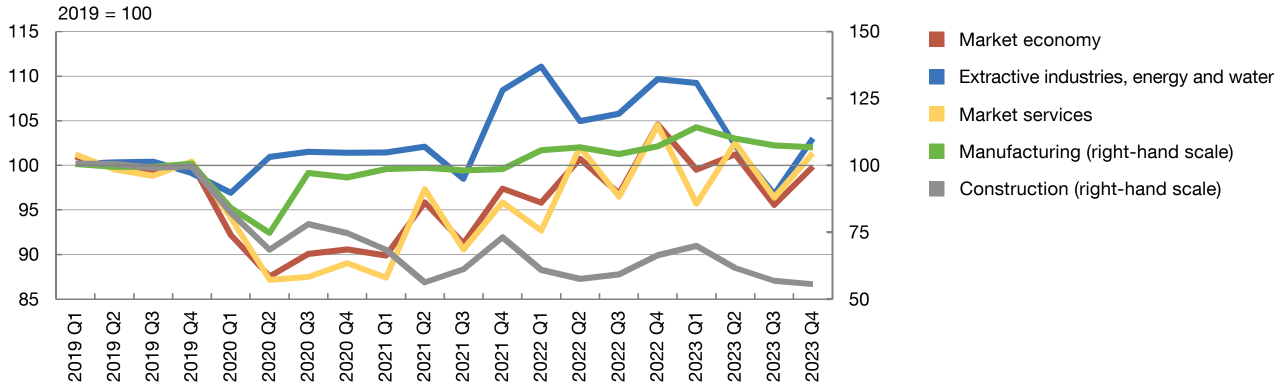
20 Profit margins remain close to their pre-pandemic levels, albeit with high cross-sector heterogeneity

— On QNA data, in 2023 the ratio of gross operating surplus (GOS) to gross value added (GVA) of the market economy remained slightly below its pre-pandemic level (see Chart 20.a). However, this aggregate performance continues to mask highly uneven cross-sector dynamics.

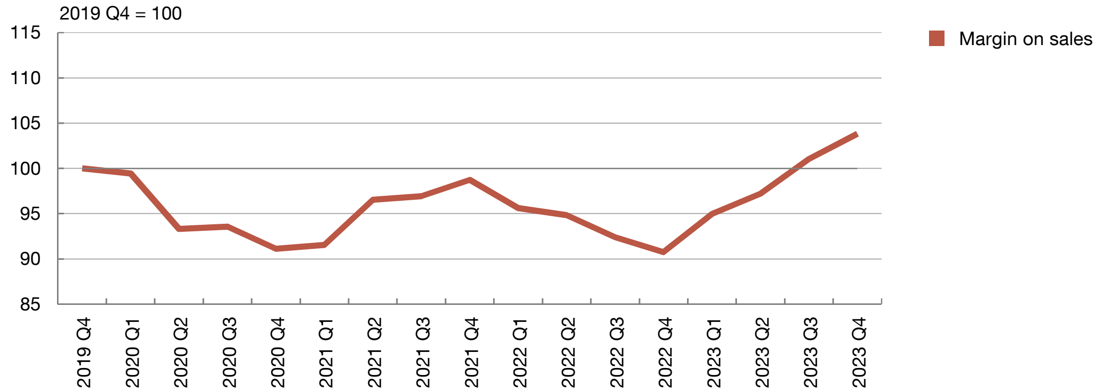
— According to Spanish Tax Agency (AEAT) information on turnover of large corporates and SMEs, net operating income (defined as the ratio of gross operating profit (GOP) to turnover) was somewhat more dynamic in 2023 (see Chart 20.b). This could have been at least partly influenced by the higher cost of borrowing that Spanish indebted firms bore throughout the year, against the backdrop of monetary policy tightening.

Chart 20

20.a Changes in profit margins (GOS/GVA) on QNA data. Breakdown by sector



20.b Changes in profit margins on AEAT data (a)



SOURCES: Banco de España, INE and tax forms for VAT and withholdings on labour income and income from economic activities (AEAT).

a All firms excluding petroleum refining (NACE 19), wholesale of fuels (NACE 4671) and gas and electricity (NACE 35) sectors. Margin on sales is defined as the ratio of GOP to turnover. Four-quarter cumulative data, current population.

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MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2024-2026)

Macroeconomic projections for the Spanish economy (2024-2026)

This section presents the key features of the most recent update to the Banco de España's macroeconomic projections for the Spanish economy for 2024-2026.[1]

Under the assumptions of the exercise, Spanish GDP – which grew by 2.5% in 2023 – is expected to slow to a growth rate of 1.9% in 2024, with this figure holding steady in 2025, before again slowing to 1.7% in 2026 (see Table 1). Meanwhile, the unemployment rate, which stood at 12.1% in 2023, will continue trending slightly downwards in the coming years, albeit remaining just above 11% in 2026. On the price front, inflation is set to decline over the projection horizon, falling from an average of 3.4% in 2023 to 2.7%, 1.9% and 1.7%, in 2024, 2025 and 2026, respectively. Core inflation will also slow gradually over the next three years, from an average rate of 4.1% in 2023, to 2.2% in 2024, 1.9% in 2025 and 1.8% in 2026.

The remainder of this section is structured as follows. First, the key assumptions and determinants underlying these projections are described. Then, the main features of the outlook for activity and prices are detailed. Lastly, some of the main risks to these projections are discussed.

Main determinants and assumptions underlying the projections

The projections are based on a set of technical assumptions regarding the expected future path of certain macro-financial and fiscal variables, which are key to assessing how activity and inflation may evolve in the coming quarters. Moreover, the new GDP data for preceding quarters mean that the starting point used to project the future paths of activity and prices has changed from the previous projections. The role that these factors play in the current projection exercise is described briefly below.

Assumptions about future energy price developments. Eurosystem projection exercises use energy commodity futures to proxy the expected future path of energy commodity prices over the projection horizon. Futures markets currently signal lower oil, natural gas and electricity prices (particularly in the case of gas and electricity) than those incorporated into the December projections, although they remain above their pre-pandemic levels (see Chart 1).

Assumptions about future interest rate developments. Based on the expectations of the international financial markets,[2] the projected paths of interest rates on the money and sovereign

1 Compared with the projections published on 19 December, these projections incorporate the new information that has become available since then. This includes, in particular, the flash Quarterly National Accounts (QNA) estimate for 2023 Q4, the Quarterly Non-Financial Accounts for the Institutional Sectors (QNFAIS) for 2023 Q3 and the changes observed in the technical assumptions for the key projection variables. The cut-off date is 15 February, except for the data on overseas markets, for which it is 9 February.

2 As in the case of oil and other commodity prices, the assumptions regarding the future paths of market interest rates are based on the prices observed in the respective markets in the ten working days prior to the cut-off date of the projections (in this case, 15 February).

Table 1
Macroeconomic projections for the Spanish economy (a)

Annual rate of change (%)

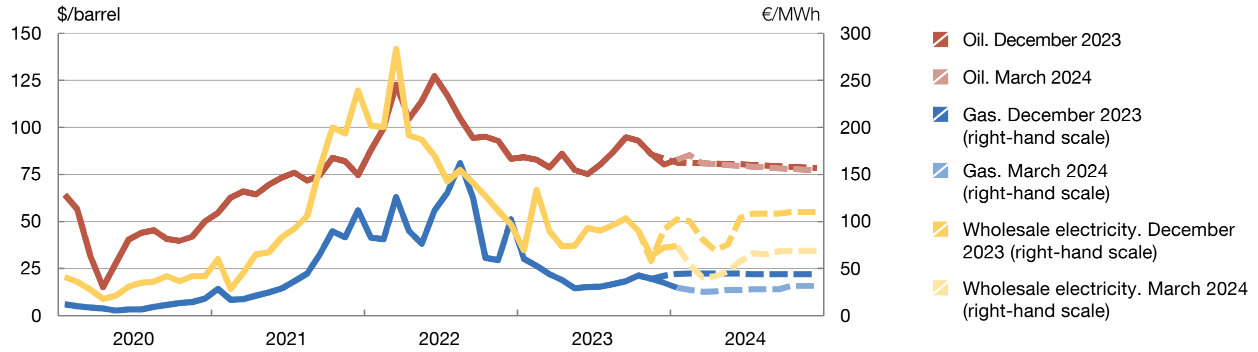
	GDP				Harmonised Index of Consumer Prices (HICP)				HICP excluding energy and food				Unemployment rate (% of labour force) (b)			
	2023	2024	2025	2026	2023	2024	2025	2026	2023	2024	2025	2026	2023	2024	2025	2026
March 2024	2.5	1.9	1.9	1.7	3.4	2.7	1.9	1.7	4.1	2.2	1.9	1.8	12.1	11.6	11.5	11.3
December 2023	2.4	1.6	1.9	1.7	3.4	3.3	2.0	1.9	4.1	1.9	1.9	1.8	12.1	11.7	11.4	11.3

SOURCES: Banco de España and INE.
NOTE: Latest QNA figure published: 2023 Q4.

a Projections cut-off date: 22 February 2024.
b Annual average.

Chart 1

1.a Energy prices



SOURCE: Mercado Ibérico del Gas, OMIE and Reuters.

debt markets have been revised downwards from the previous projection exercise (see Table 2). Accordingly, the cost of new lending between 2024 and 2026 is also now expected to be lower than anticipated three months ago. That said, it is worth noting that interest rates will remain relatively high throughout the entire projection horizon.

Assumptions about future external market developments. In step with the outlook for global economic activity in the coming quarters and, in particular, for euro area economic growth, the technical assumptions envisage a gradual recovery in Spain's export markets in the coming years. Nonetheless, the pace at which such markets are expected to grow in 2024 has been revised slightly downwards from the December projections (see Table 2). This revision is primarily due to the fact that activity in the euro area in the final stretch of 2023 was less robust than had been anticipated in December. Meanwhile, compared with the previous projection exercise, the nominal effective euro exchange rate has depreciated somewhat.

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

Annual rate of change (%), unless otherwise indicated

		March 2024 projections			Difference between the current projections and the December 2023 projections (b)		
	2023	2024	2025	2026	2024	2025	2026
Spain's export markets (c)	-0.1	1.4	3.1	3.1	-0.8	0.1	0.2
Oil price in dollars/barrel (level)	83.7	79.8	75.2	73.1	-0.3	-1.4	-0.5
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1.08	1.08	1.08	1.08	-0.01	-0.01	-0.01
Nominal effective exchange rate against non-euro area countries (d) (2000 = 100)	115.6	115.5	115.4	115.4	-1.1	-1.2	-1.2
Short-term interest rate (3-month EURIBOR; level) (e)	3.4	3.4	2.5	2.3	-0.2	-0.4	-0.4
Long-term interest rate (10-year Spanish government bond yield; level) (e)	3.5	3.3	3.4	3.5	-0.3	-0.4	-0.4

SOURCES: Banco de España and ECB.

a Cut-off date for assumptions: 9 February for Spain's export markets and 15 February for all other variables. Figures expressed as levels are annual averages; figures expressed as rates are calculated on the basis of the related annual averages.
b Differences in rates for export markets, in levels for oil prices, the dollar/euro exchange rate and the nominal effective exchange rate, and in percentage points for interest rates.
c The assumptions regarding the behaviour of Spain's export markets presented in the table are obtained from the March 2024 *Eurosystem staff macroeconomic projections for the euro area*.
d A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
e For the projection period, the figures in the table are technical assumptions, prepared following the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the path of these variables.

Assumptions about fiscal policy in Spain.

— The new fiscal assumptions now factor in the extension to 2024 (approved in late December 2023) of some of the support measures in place during 2023 to address the surge in inflation. Specifically, in addition to the extension of certain measures already anticipated in the December projections (e.g. the extension to June of the transport subsidies and the reduced VAT rate on food), the partial extension of the energy tax reductions from January onwards has also been included.[3] These projections also now include the extension of the wealth tax.[4] Overall, compared with the December forecast,

3 First, VAT on electricity and natural gas rose from 5% to 10% in January, as opposed to the 21% envisaged in the December projections on the understanding that the measures would be withdrawn in full. Based on the information available at the cut-off date for these projections, VAT on natural gas will again be charged at 21% from 2024 Q2 onwards. In the case of electricity, the VAT rate in 2024 will return to 21% for any month where the average wholesale market price in the month preceding the reference month is equal to or lower than €45/MWh, a requirement that, based on the most recent developments and the futures market prices, will be met in four months during 2024. Meanwhile, in the first quarter of 2024 the excise duty on electricity has risen from 0.5% to 2.5%, and is set to rise to 3.8% in Q2 and to 5.1% from Q3 onwards (i.e. tantamount to withdrawing the measure in full). See Royal Decree-Law 8/2023 of 27 December 2023.

4 Initially approved for 2023 and 2024, this tax has been extended until such time as wealth taxation is reformed as part of the overhaul of regional government funding. Moreover, on 6 February the Government approved a reform to reduce personal income tax withholdings so as to exempt the lower levels of employment income (around the national minimum wage).

these new measures are expected to increase the budget deficit by 0.2 percentage points (pp) of GDP in 2024, while barely having any impact in the two following years.

— The assumptions regarding the expenditure and investment financed with funds from the European NGEU programme remain unchanged from the December projections. Such expenditure and investment is expected to have its biggest impact on Spanish GDP between 2025 and 2026.

— All told, bearing in mind the impact of the NGEU programme, these projections anticipate a slightly contractionary fiscal policy stance in 2024, albeit less so than envisaged in the December exercise. Over the rest of the projection horizon, and in the absence of additional measures, the fiscal policy stance is likely to be virtually neutral. It is important to note here that a contractionary stance will be needed from 2025 onwards once the EU's new fiscal rules have been rolled out.

New data and statistical revisions. The flash QNA estimate for 2023 Q4 points to higher GDP growth in the quarter (0.6%) than had been anticipated by the Banco de España in its December projections (0.3%).[5] The GDP growth rate was also revised up for 2023 Q2 (from 0.4% to 0.5%) and 2023 Q3 (from 0.3% to 0.4%). Taken on their own, these new figures would automatically entail a higher starting point for GDP for the current projections exercise and a higher GDP growth rate in 2024.

Activity

The growth rate of the Spanish economy quickened unexpectedly in the last quarter of 2023, although private consumption and gross fixed capital formation surprised on the downside. As noted above, according to the QNA flash estimate published by the INE,[6] GDP grew quarter-on-quarter by 0.6% in Q4, significantly exceeding the Banco de España's December projections (0.3%) and the figure observed in the preceding quarter (0.4%). Nonetheless, this growth was the result of very contrasting dynamics in the main demand components. On the one hand, changes in inventories (a highly volatile component in recent years) made a notably positive contribution to output growth (0.5 pp). Government consumption also showed surprisingly strong momentum, a state of affairs that appears to have led to a 3.8% increase in this component for 2023 overall, surpassing the rates seen in 2020 and 2021 at the height of the health crisis. On the other hand, both private consumption and gross fixed capital formation performed worse than expected. The former due to a sharper than anticipated deceleration, growing at a rate (0.3%) far short of the increase (1.2%) recorded in Q3. Gross fixed capital formation contracted somewhat sharply (by 2%) across most components, with a particularly notable decline (of 4.8%) in investment in capital goods and machinery. Should it persist, the relative weakness of these two demand components, which tend to underpin stable growth in any economy, could undermine

5 See "Macroeconomic projections for the Spanish economy (2023-2026)". *Economic Bulletin - Banco de España,* 4/2023.

6 Note that the data offered by the QNA for 2023 Q4 is still provisional, and may therefore be revised.

the ability of the Spanish economy to maintain the sizeable momentum seen in late 2023 in the coming quarters.

The latest short-term economic indicators suggest that economic growth in Spain may have decelerated slightly in 2024 Q1. Specifically, according to these indicators, the growth rate of private consumption has been similar in early 2024 to that observed in 2023 Q4, while business investment remains somewhat sluggish. Government consumption and inventories also appear to have lost steam, after posting robust growth in 2023 Q4. In the case of inventories, the most recent evidence suggests that when these make a large positive contribution to growth in one quarter, the contribution of stockbuilding in the following quarter is often negative.[7] On balance, an overall assessment of the various indicators available for 2024 Q1 – such as the Banco de España Business Activity Survey (EBAE), social security registrations and Purchasing Managers' Indices – is compatible with quarter-on-quarter GDP growth slowing to 0.4% in the period.

Looking beyond Q1, GDP growth is expected to remain relatively stable, converging over the projection horizon towards rates consistent with the Spanish economy's growth potential. This outlook reflects the net impact on economic growth of multiple factors, of different strengths and effects and over varying time frames. For example, GDP growth over the coming quarters will benefit from factors such as the adverse impact of monetary policy tightening on activity fading away, projected population growth, the gradual recovery of the European and global economy and the larger roll-out of NGEU funds. On the other hand, however, it will be adversely impacted, inter alia, by the petering out of some of the tailwinds driving recent growth (such as significant pent-up demand for certain goods and services and the sharp correction of some negative supply shocks that weighed on activity in 2021 and 2022) and the persistence of considerable geopolitical tensions. All told, an overall assessment of these factors suggests that, 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 Table 3).

While net external demand and government consumption made a notable contribution to GDP growth in 2023, private consumption and investment will be the main drivers of Spanish economic activity in the years ahead (see Chart 2). In the coming quarters, household consumption, which did not return to pre-pandemic levels until end-2023, will be boosted by population growth, higher real incomes (associated with easing inflation rates), strong job creation and projected wage rises. Moreover, after presenting considerable weakness throughout 2023, gross fixed capital formation will increase over the projection horizon, underpinned by the galvanising effect expected from NGEU projects (whose roll-out should gain traction in 2024 and 2025) and by the waning of the adverse impact of cumulative monetary policy tightening. Nevertheless, investment will continue to be the demand component that takes longest to return to pre-pandemic levels. Net external demand will make virtually no contribution to GDP growth in 2024-2026, mainly due to imports recovering – in step with the growth of final demand and gross

7 For example, stockbuilding made a positive contribution to GDP growth of 1.1 pp in both 2021 Q4 and 2022 Q4. In the following quarter, the contribution of this component was -0.7 pp and -0.5 pp, respectively.

Table 3

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

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

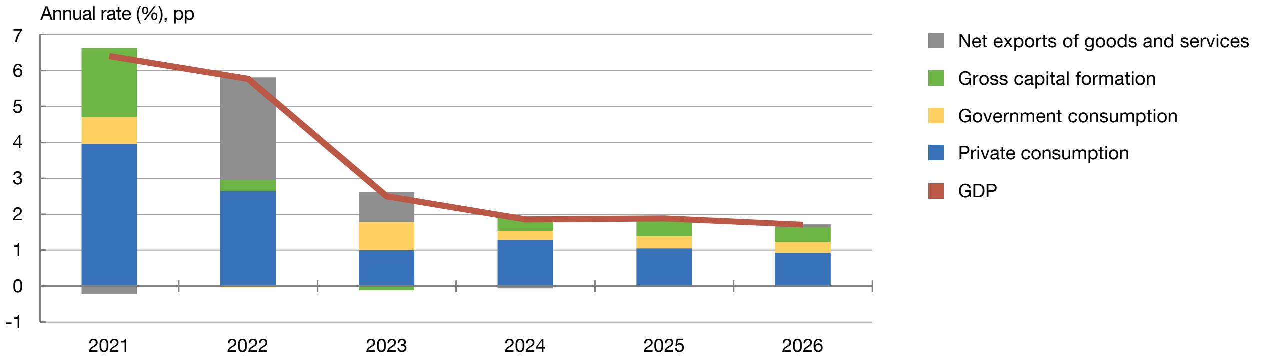
		March 2024 projections			December 2023 projections		
	2023	2024	2025	2026	2024	2025	2026
GDP	2.5	1.9	1.9	1.7	1.6	1.9	1.7
Private consumption	1.8	2.3	1.9	1.7	2.3	1.7	1.5
Government consumption	3.8	1.2	1.7	1.5	0.8	1.5	1.3
Gross fixed capital formation	0.6	0.4	2.7	1.9	2.7	2.7	1.8
Exports of goods and services	2.4	1.7	3.0	2.9	0.3	3.0	2.9
Imports of goods and services	0.3	2.1	3.4	3.0	1.3	3.0	2.7
Domestic demand (contribution to growth)	1.7	2.0	1.9	1.6	2.0	1.8	1.5
Net external demand (contribution to growth)	0.8	-0.1	0.0	0.1	-0.4	0.1	0.2
Nominal GDP	8.6	4.8	4.1	3.6	4.2	4.2	3.8
GDP deflator	5.9	2.9	2.2	1.9	2.6	2.3	2.1
HICP	3.4	2.7	1.9	1.7	3.3	2.0	1.9
HICP excluding energy and food	4.1	2.2	1.9	1.8	1.9	1.9	1.8
Employment (hours)	1.9	1.8	1.1	0.9	1.3	1.1	0.9
Unemployment rate (% of labour force). Annual average	12.1	11.6	11.5	11.3	11.7	11.4	11.3
Net lending (+)/net borrowing (-) of the nation (% of GDP)	3.6	3.4	3.5	3.6	2.9	3.0	3.0
General government net lending (+)/net borrowing (-) (% of GDP)	-3.8	-3.5	-3.5	-3.5	-3.4	-3.6	-3.6
General government debt (% of GDP)	107.7	106.5	107.2	108.4	106.3	107.2	108.4

SOURCES: Banco de España and INE.
NOTE: Latest QNA figure published: 2023 Q4.

a Projections cut-off date: 22 February 2024.

Chart 2

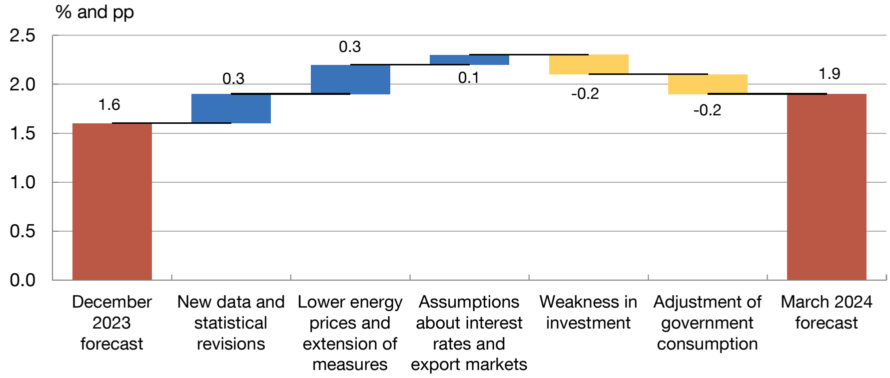
2.a GDP growth and contributions of main components



SOURCES: Banco de España and INE.

Chart 3

3.a Changes in the GDP growth forecast for 2024



SOURCES: INE and Banco de España.

fixed capital formation, which has a high import content – in a context in which exports of goods and services will also be relatively buoyant.

Compared with the December projections, GDP growth has been revised up in 2024 and is unchanged in 2025 and 2026. The average GDP growth rate for 2024 has been revised up by 0.3 pp to 1.9% (see Chart 3). This revision reflects the inclusion of the following elements, which operate in different directions:

— The new QNA data for 2023 Q4 – which present stronger than expected output growth – and the upward revisions to the GDP growth rates for the preceding two quarters have a positive carry-over effect on the average GDP growth rate of 0.3 pp for 2024.

— Other contributors to the upward revision to GDP growth for 2024 vis-à-vis December are the lower energy prices observed on the international markets in recent months, a more favourable outlook regarding the future course of such prices and the more gradual withdrawal of the measures deployed by the authorities to combat the effects of the inflationary episode.

— Based on the latest technical assumptions, the path of interest rates is now projected to be lower. This revision also gives a greater boost to economic activity over this year, by way of more favourable financing conditions for agents.[8]

— The weakness observed in gross fixed capital formation in recent quarters, along with firms' more negative outlook for 2024 Q1 compared with three months ago (according to

8 It should be noted that, for 2024, the favourable impact of lower interest rates on GDP growth more than offsets the slightly negative effect on output growth associated with the weaker momentum in Spanish export markets envisaged in this projection exercise.

EBAE data), will lead to investment being less robust in the more immediate future. This will push down the rate of GDP growth for 2024 compared with that projected in December.

— Strong government consumption in the last few months of 2023 meant that general government spending at year-end was significantly higher than envisaged in the December projections. This will result in less leeway for expansion in the coming quarters and, thus, slower GDP growth for 2024.

Turning to the labour market, employment is expected to lose some momentum over the projection horizon, resulting in a slight pick-up in productivity. Job creation in the final stretch of 2023 was higher than expected a few months ago – in keeping with the performance of activity – and could remain buoyant, as suggested by the indicators available for the first few months of 2024. Therefore, compared with the December projection exercise, expected employment growth has been revised up in 2024, but the deceleration projected for 2025 and 2026 remains unchanged. As a result, and despite the upward revision to GDP, apparent labour productivity will remain considerably weak in 2024, but is expected to rise slightly over the rest of the projection horizon. Meanwhile, the unemployment rate will continue to decline in the coming years, albeit at a slower pace than in previous years, owing to the expected moderation of job creation and the projected growth of the labour force, which, in line with figures for recent years, will be driven by strong immigration flows. As a result, the unemployment rate will hold at over 11% in 2026.

Prices and costs

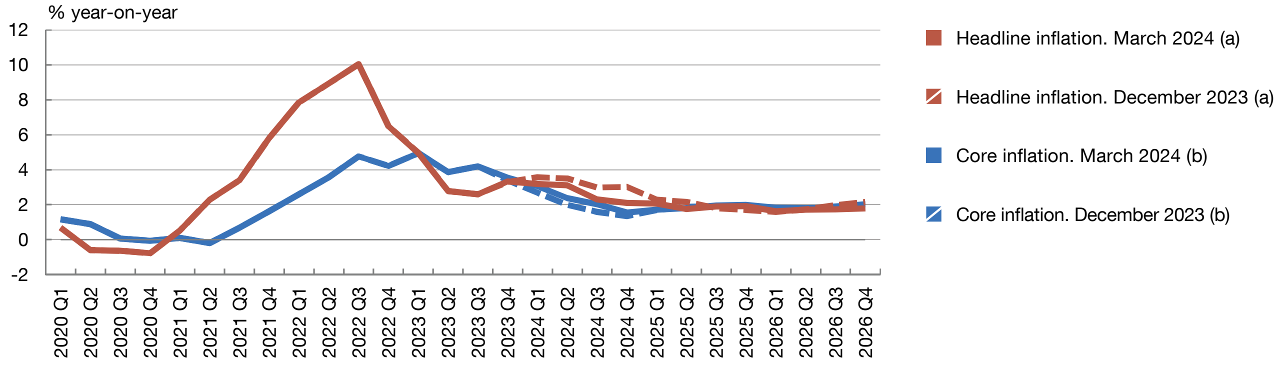
After rising slightly in January, headline inflation declined in February. Specifically, the year-on-year rate of change in the harmonised index of consumer prices (HICP) stood at 2.9% in February, compared with 3.5% in January and 3.3% in December. The higher inflation in January was primarily due to the impact of the partial reversal of some of the tax measures taken by the Government to mitigate the effects of rising inflation.[9] Nevertheless, this impact would have been significantly greater had the tax measures on energy prices been fully reversed, as was assumed in the December projection exercise. The slowdown in headline inflation in February was chiefly attributable to electricity prices being more contained, which more than offset the increase in fuel prices, following the declines recorded in previous months. In any event, compared with the December projection exercise, and after factoring in the impact of the partial reversal of the tax measures in January, the energy component appears to have surprised on the downside in recent months.

According to the more disaggregated data available to January, underlying inflation has held on a path of gradual deceleration in recent months, albeit at a slightly lower pace than expected in December, whereas food prices rose somewhat. Underlying inflation

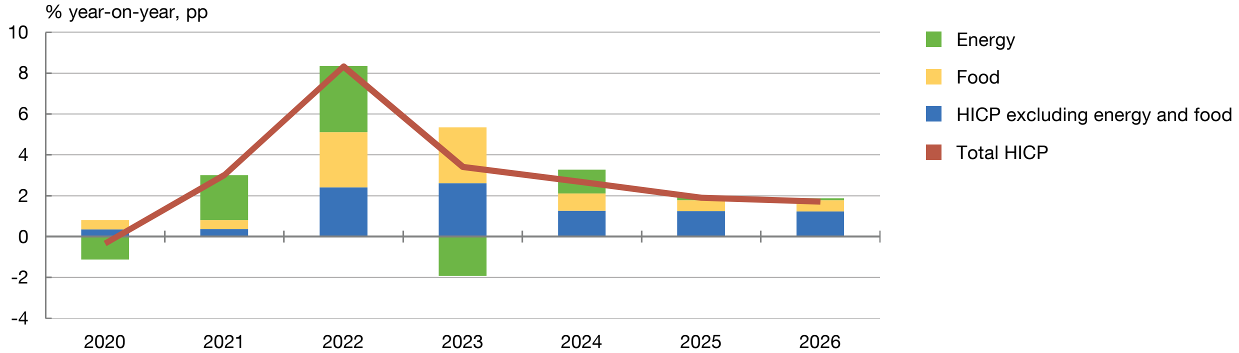
9 Specifically, the VAT rate on electricity and gas was increased from 5% to 10% on 1 January 2024, and the excise duty on electricity from 0.5% to 2.5%. These changes would have entailed an automatic rise in the January inflation rate of close to 0.3 pp.

Chart 4

4.a Headline and core inflation



4.b Contributions to HICP growth by component



SOURCES: INE and Banco de España.

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

declined by 0.3 pp in January to 3.2%, owing mainly to the loss of momentum in the prices of recreation, hospitality and tourism services and in those related to housing maintenance and repair. However, this moderation in underlying inflation was not as strong as expected. One noteworthy factor that may lie behind this surprise is clothing and footwear prices. Recent developments in these prices appear to be consistent with a more forceful than expected pass-through of past increases in producer prices, which seems to have been reflected, at least in part, by the smaller price discounts made during sales compared with previous years' estimates. Meanwhile, the higher growth rate of food prices was mainly attributable to base effects stemming from the VAT rate reduction for some foods in January 2023, as projected in December. However, the increase was slightly sharper than expected, owing to the downward stickiness of the price of certain foods whose production has been particularly affected by adverse weather conditions, such as fruit, vegetables and olive oil.

Inflation is expected to resume a downward path over the coming months (see Chart 4.a). This would reflect a gradual easing in food and core inflation, which should more than offset the increase in the contribution of the energy component. Indeed, the rate of change in the energy HICP, which stood at close to -9% in 2023 Q4, looks set to rise to around 2% at end-2024. Much of this increase would be associated with the above-mentioned gradual withdrawal of the tax measures.

Food inflation will continue to ease throughout the projection horizon (see Chart 4.b). The main driver behind this projected cooling of food inflation is the lower cost of several key production inputs, such as energy and fertilisers, with this decline also being reflected in food commodity prices. For its part, the reduced VAT rate on food has been extended to June 2024, which will help to contain food prices in the first half of the year but exert slight upward pressure in the second half.[10]

Meanwhile, core inflation will continue to slow over the course of this year and reach an average rate of around 2% in 2025-2026 (see Chart 4.a). The factors contributing to these developments over the coming quarters will include, inter alia, the impact on demand of the cumulative monetary tightening and the gradual pass-through to non-energy industrial goods and services of recent declines in energy prices. In addition, the public transport subsidies currently in force have been extended to the entirety of 2024, which will exert downward pressure on core inflation this year, but will have the opposite effect in 2025 when the measure is scheduled to expire.

In line with developments in recent quarters, no significant second-round effects on inflation are expected. In particular, developments in wage settlements are expected to remain in line with the fifth Employment and Collective Bargaining Agreement, with annual increases of around 3% over the projection horizon. However, compensation per employee will continue to rise at a somewhat faster pace than wage settlements, particularly in 2024, essentially due to a slightly positive wage drift. Meanwhile, profit margins are expected to remain relatively contained, such that they can accommodate the anticipated increases in unit labour costs (in a context in which compensation per employee continues to outpace productivity).

Considering all these developments, headline inflation will gradually ease from 3.4% in 2023 to 2.7% in 2024, 1.9% in 2025 and 1.7% in 2026. Core inflation, which in 2023 stood at 4.1% in annual average terms, will decline to 2.2% in 2024 and fall slightly further over the following two years.

Compared with the previous projections, headline inflation for 2024 has been revised down considerably. Specifically, the average headline inflation rate now projected for 2024 is 0.6 pp lower than envisaged in December. This revision essentially owes to the net impact of several factors pulling in opposite directions (see Chart 5.a):

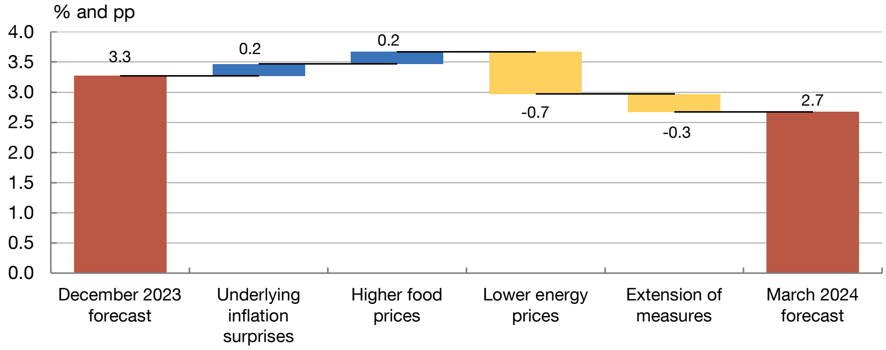
— The lower energy prices observed over the last few months and the current more favourable futures market expectations as to the course of such prices over the coming quarters result in a downward revision of 0.7 pp in average headline inflation for 2024.[11]

10 In line with the measures approved by the Government, it is assumed that in June 2024 the VAT rate on certain staple food products will return to 4% (from 0% at present) and that on other food products will revert to 10% (from 5% at present). This assumption was also included in the December projections.

11 The latest projection assumptions envisage lower energy prices throughout the horizon, which also entail a downward revision to the inflation rates projected for 2025 and 2026. However, for 2025, this downward revision is offset by the positive impact of the expiry, scheduled for that year, of the measures rolled out by the authorities to tackle the spike in inflation, which will remain in force in 2024.

Chart 5

5.a Changes in the inflation forecast for 2024



SOURCES: INE and Banco de España.

— The partial extension (not envisaged in the December projections) of some of the measures deployed by the authorities to mitigate the effects of the inflationary episode entails a downward revision of 0.3 pp to the average inflation rate projected for this year.

— The recent upward surprises in underlying and food inflation lead to a slight upward revision of both of these inflation paths, resulting in somewhat more persistent inflationary pressures in these goods and services than projected in December. As noted above, these surprises were essentially associated with more adverse weather conditions than expected and a stronger pass-through of past increases in clothing and footwear production costs. The new trajectories for underlying and food inflation each entail a 0.2 pp revision to the average headline inflation rate for 2024.

Main risks to these projections

The risks to the economic growth projections are on the downside, while the risks to the inflation projections are considered to be balanced.

As in previous projection exercises, the main sources of risk to this exercise are global geopolitical uncertainty and, in particular, a potential escalation in the ongoing conflicts in Ukraine and the Gaza Strip. Indeed, the flare-up of tensions in the Red Sea region over the last few months has triggered a sharp increase in shipping costs and driven up the indicators used to proxy the severity of global supply chain bottlenecks. However, with moderate global demand dynamics and no discernible signs of significant congestion in logistics networks or global supply chains, these shocks appear to be having a limited impact on inflation and activity for the time being.[12] That said, it is impossible to rule out a more adverse scenario in which the persistence or a potential escalation of these tensions gives rise to more adverse supply shocks that exert greater

12 Viani (2024).

downward pressure on activity and more upward pressure on inflation than envisaged in the baseline scenario of these projections. Indeed, according to the EBAE, roughly half of the Spanish industrial and trade firms surveyed reported having been affected by these tensions.

The impact of the cumulative monetary tightening on activity and prices is another significant source of uncertainty. The weakness of economic activity and the easing of inflation observed in the euro area in recent quarters – both of which have been more pronounced than expected – could indicate a stronger transmission of monetary policy than envisaged in these projections. Also pointing in this direction are the downward surprises in lending to the private sector, of which there have been several in the last few quarters. In any event, quantifying these effects is a complex task and caution should therefore be exercised when attempting to interpret the potential impact of monetary policy conduct on the main macro-financial aggregates. Such caution is particularly warranted when, as in the current scenario, multiple concurrent shocks and public policies are influencing developments in economic activity and prices. A data-dependent approach is therefore imperative to monitor these developments on an ongoing basis over the coming months.

Other significant sources of uncertainty surrounding the baseline scenario of these projections are on the domestic front and relate to potential second-round effects on inflation and the roll-out of NGEU funds. First, a faster than expected increase in wages and/or profit margins would entail a higher inflationary path than envisaged under the baseline scenario of these projections. For the time being, the pace of the moderation in inflation and the developments observed in profit margins and wages do not point in this direction. However, the possibility of stronger feedback loops between prices and wages and/or profit margins going forward cannot be ruled out entirely, particularly when compensation per employee is outpacing wage settlements and the labour market is showing considerable tightness.[13] In fact, underlying inflation in Spain has cooled less quickly than expected, and therefore caution should be exercised before assuming that the current inflationary episode is under control. Moreover, doubts persist regarding the pace of execution of the NGEU-related projects and their impact on activity. As has been noted, investment in Spain has surprised on the downside in recent quarters. This weakness, should it prove more persistent than expected, could weigh on activity and inflation over the projection horizon.

Lastly, the reactivation of the European fiscal rules (suspended since the onset of the pandemic) poses a considerable risk to the baseline scenario of these projections. Compliance with these rules will require the design and implementation of a medium-term fiscal consolidation plan that lays the foundations for a more pronounced correction of the structural public deficit than envisaged in these projections. The economic impact of this adjustment plan remains uncertain and will crucially depend on how it is designed. However, its implementation would likely result in lower momentum in activity over the projection horizon than envisaged in this projection exercise.

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13 Ghomi, Hurtado and Montero (2024).