

Annual Report: Digest

Chapter 1

The resilience of the Spanish economy in the European context

Global inflation has continued to ease, owing especially to falling energy prices, while global economic activity has remained somewhat buoyant

- Falling energy commodity prices and the fading of previous years' adverse supply shocks influenced developments in the global economy in 2023.
- The central banks of the main developed economies continued to tighten their monetary policy throughout 2023, before pausing policy rate rises in the second half of the year.
- In this setting, global economic activity slowed somewhat over the course of 2023, although it remained more dynamic than initially expected, except in the euro area, where growth was more lacklustre than anticipated.
- Headline inflation rates have been falling worldwide, although underlying inflation has declined more gradually.
- Looking ahead, the forecasts available envisage global economic growth stabilising somewhat, as well as the European economy recovering gradually and global inflation continuing to ease.

The raising of the European Central Bank's (ECB) key interest rates increased the cost of new financing for households and firms in 2023. However, these cost increases tapered off in the second half of the year and had a limited impact on household and firms' vulnerability and the credit quality of banks' balance sheets

- The ECB continued to reduce the size of the Eurosystem's balance sheet throughout 2023 and raised key interest rates up to September 2023, when the deposit facility rate reached 4%, keeping them unchanged since then.
- Over the course of 2023, the interest rates on new financing for Spanish households and firms increased in step with risk-free rates. Nevertheless, this growth tapered off in the second half of the year and even reversed in Q4.
- The cumulative increase in interest rates on new lending in the current monetary policy tightening cycle has been weaker than in the euro area and also smaller than what the historical regularities would suggest.
- Loan supply and demand and the outstanding amount of financing contracted in all segments in Spain in 2023, with the exception of consumer credit, which continued to rise.
- The current rate hiking cycle has had a limited impact on households' and firms' vulnerability (amid an increase in household income and firms' profits) and the credit quality of Spanish banks' balance sheets and has lifted the latter's net interest income.

The Spanish economy showed strong momentum in 2023 – more so than other euro area countries and more than expected in early 2023 – driven by robust government and private consumption and services exports, while investment has been weak

- Growth in Spain was notably resilient in 2023, with GDP growth at 2.5%, more than the 1.6% forecast at the beginning of the year and outstripping the euro area overall (0.4%).

- The upward surprises in exports of travel services and government consumption, along with the positive carry-over effect resulting from the statistical revisions that affected 2022, were the main drivers of the higher than expected GDP growth.
- The boost provided by domestic demand and greater resilience to the energy shock explained Spain's stronger economic activity compared with the euro area as a whole.
- Job creation in Spain remained highly buoyant, amid declines in apparent labour productivity and some labour market tightening.
- Household spending was the main driver of GDP growth, while investment was notably weak.
- Net external demand bolstered activity, thanks to the strength of exports – especially travel services – and weakness in imports, which widened Spain's current account surplus.
- Government consumption and social benefits further underpinned activity, although the partial withdrawal of some of the support measures implemented in response to the energy crisis and the strength of Government revenues resulted in a slightly contractionary fiscal stance.
- The high growth rates in tourism-related services sectors accounted for around half of the overall growth in 2023, standing in contrast to the sluggishness recorded in the industrial sectors, thus continuing Spain's secular shift towards a more services-based economy.

Headline inflation in Spain remained on the easing path that began in 2022 Q3 – which was even more pronounced than anticipated owing to the unexpected decline in energy prices – while underlying inflation and compensation per employee surprised slightly on the upside over the course of 2023

- The drop in energy prices has been decisive in shaping the disinflationary path in Spain, although food prices and underlying inflation have displayed greater downward stickiness.
- Inflation followed a steeper easing path during 2023 than had been forecast at end-2022, mainly due to the unexpected drop in energy prices.
- Compensation per employee increased significantly in 2023 – more than initially expected –, although the corresponding impact on domestic inflationary pressures was cushioned by the slowdown in unit operating surpluses.

Looking ahead, expectations point to the Spanish economy remaining notably buoyant and inflation continuing on its moderating path

- The gradual revival of the European economy, the moderation in inflation and the subsequent recovery in agents' real incomes, together with the fiscal impulse stemming from the NextGenerationEU (NGEU) programme, will help to underpin activity in Spain over the coming years. However, the uncertainty surrounding the economic outlook is very high.
- One particularly important source of uncertainty for Spain's economic outlook is the vulnerability associated with fiscal sustainability, especially with the EU fiscal rules coming back into force.
- In addition, the lack of convergence towards the level of per capita income in the euro area as a whole highlights the need to address a series of structural challenges linked to the persistent weaknesses seen in the Spanish economy in recent years (see Chapter 2 of this report).

Chapter 2

Structural challenges facing the Spanish economy

The Spanish economy's growth capacity over the years ahead will be influenced by a number of far-reaching structural challenges

- The structural challenges facing the Spanish economy are linked to sluggish productivity growth (which in turn is associated with the need to build up human and technological capital and strengthen the institutional framework), population ageing and the sustainability of public finances, and the green transition, all in a setting in which pockets of vulnerability persist among certain groups.
- If these challenges are to be successfully addressed, rigorous analysis of the different areas, together with design and implementation of a comprehensive strategy of ambitious and lasting structural reforms, based on broad consensus, is needed.
- The Next Generation EU (NGEU) programme and the Spanish Recovery, Transformation and Resilience Plan (RTRP) present a unique opportunity to develop this strategy, via a rigorous selection of the investment projects to be funded through the NGEU and ambitious implementation of the other reforms and milestones pending under the RTRP.

Productivity, firm size and firm demography

- In recent decades, the Spanish economy has seen a productivity slowdown that has been significantly more pronounced than in other developed countries.
- The factors behind the slow aggregate productivity growth in the most recent period notably include the small contribution of net firm entry – compared with other European countries – on account of the lower business churn rate.
- However other factors, such as the small size and low growth of active firms in Spain, also limit aggregate productivity dynamics, while the reallocation of resources between firms and sectors has played a more minor role in recent years.
- The recent initiative to create a National Productivity Board could be an important lever to enhance analysis of the productivity of the Spanish economy and foster proposals for policies to boost productivity, although if it is to be effective, it will need to ensure the independence and professional expertise of its members and be endowed with sufficient resources to undertake rigorous analyses.

Human capital

- Despite the improvement observed in recent decades, the educational attainment level of the Spanish population remains below the European average, so structural measures must be adopted to continue to encourage students to remain in education.
- There appears to be some mismatch between the supply of and demand for places at conventional (classroom-based) public universities.
- It is essential to ensure that Spanish firms have the right incentives to create sufficient places for students on the dual vocational training system.

Capital investment and innovation

- In recent decades, the low level of innovation and technological capital in the Spanish economy is a key explanatory factor of the relative sluggishness of Spanish productivity.
- In this setting, although there has been strong growth in intangible investment in recent years, this momentum has not been sufficient to close the gap with average euro area levels.
- To encourage business investment and innovation, providing a regulatory framework and a stable institutional environment, smoothing access to external financing and reviewing the efficiency and design of the system of tax incentives for innovation would all be desirable.

Institutional framework

- According to different indicators available, institutional quality and trust have deteriorated since the financial crisis and this has had a negative impact on long-term growth.
- Action is needed to boost the efficacy and efficiency of Spanish general government; this would help lift productivity and would have a positive spillover effect on private sector expenditure, investment and innovation decisions.

Population ageing

- In recent decades, demographic trends in Spain have been marked by a significant drop in both fertility and mortality rates. As a result, life expectancy has increased and is now higher in Spain than in other developed countries, although this is not the case in terms of healthy life expectancy.
- In this setting, the population ageing process has gathered considerable pace, and will continue to do so over the coming decades, more so in Spain than in other European countries.
- Migration flows have surged in recent years, but it seems unlikely that this will offset population ageing in Spain or effectively smooth any mismatches that might arise in the Spanish labour market.

Inequality and pockets of vulnerability among households

- In recent years, income inequality has declined significantly in Spain, against a backdrop of strong employment growth. However, some pockets of vulnerability, largely linked to housing affordability difficulties, have been observed among some groups.
- The correlation between parents' level of educational attainment and that of their adult offspring decreased in the second half of the 20th century, suggesting greater intergenerational mobility and, therefore, more equality of opportunity.

Public finances

- The public finances imbalance remains very high, both by historical and international standards, and has even worsened since 2019, as the notable growth in public revenue has been more than offset by the sharp increase in public expenditure.
- The pension system is one of government's most important expenditure items and one that has seen the most growth in recent years. An overall analysis of the major regulatory changes introduced between 2021 and

2023, while subject to considerable uncertainty, points to higher long-term expenditure obligations that are not fully offset on the revenue side.

- In this setting, the macroeconomic and fiscal dynamics of the Spanish economy highlight the need to implement, without delay, a medium-term fiscal consolidation plan that strengthens the sustainability of public finances.
- Moreover, it is essential that the Spanish economy take advantage of economic upturns to build up fiscal space that will allow it to counter the recessionary effect on activity of any future adverse macro-financial shocks.
- In this respect, the new European fiscal governance framework will require, in the coming years, significant fiscal adjustments in some countries in the form of medium-term budgetary plans prepared by Member States setting a multi-year expenditure path.

Green transition

- The fight against climate change and the transition to a more sustainable economy is one of the key challenges facing society today. In particular, the Iberian Peninsula could be significantly affected by the physical risks associated with climate change.
- The energy transition will not only require large-scale deployment of renewable energy sources and improved energy interconnections within the EU, but also a determined commitment to energy efficiency gains.
- The green transition also presents a considerable challenge for central banks and the financial system, insofar as this profound structural change could significantly affect monetary policy conduct and pose considerable risks to financial stability.

Chapter 3

The Spanish labour market: current developments, structural trends and labour market policies

Recent Spanish labour market developments have mainly been marked by employment's considerable momentum

- According to the Spanish Labour Force Survey, between 2019 Q4 and 2023 Q4 1.28 million jobs were created in Spain, 783,000 of them in 2023, and the employment rate (proportion of the population aged 16-64 in employment) rose by 2.2 pp, from 63.7% to 65.9%.
- Employment has grown with considerable heterogeneity across sectors, occupations and regions.
- Employment has grown more in the public sector than in the private sector. In 2019-2023 the number of salaried workers in the Spanish public sector increased by 340,000, at an average annual growth rate of 2.4%, compared with 1.7% in the private sector.
- The recovery in migratory flows has contributed considerably to employment's recent strength. Foreign nationals accounted for 54% of the 1.06 million new persons employed in 2022-2023.
- Compared with the considerable buoyancy of the number of persons employed, hours actually worked have grown considerably less and hours worked per person employed have decreased.
- In contrast to employment, labour productivity has barely increased. This, coupled with growth in compensation per employee, has driven the rate of growth of unit labour costs higher than that observed in the euro area as a whole.

The labour market is showing signs of tightness, despite the unemployment rate in the Spanish economy remaining excessively high

- The unemployment rate was 11.8% at end-2023, the lowest since 2008, but still double that of the EU-27.
- A considerable portion of the cross-country differences in unemployment rates are related to the very institutions and policies that have a direct impact on the functioning of the labour market.
- Firms perceive labour shortages as one of the main constraints on their productive activity.
- The reasons for the labour market tightness vary across sectors and occupations.

A new wave of technological change will prompt a shift in the division and organisation of labour. Productivity will be boosted, but to the detriment of employment in certain sectors and occupations

- The development of robotics and artificial intelligence (AI) could make it possible to automate productive tasks across all occupations, including those requiring a higher level of professional qualification.
- Labour demand has so far increased relatively more in occupations that are potentially more exposed to robotics and AI developments.
- Exposure to new technologies and their degree of complementarity with human work will determine which workers will be displaced and which will benefit from further increases in productivity.

- Complementarity with robotics and AI will foreseeably be greater for workers who understand how these new technologies work and who are able to provide added value to the tasks carried out by robots and algorithms. Conversely, those workers who are limited to a small number of tasks – whether routine, manual or otherwise – are likely to be displaced by the new technologies.
- Demographic shifts are profoundly changing the composition of the working population by age group and will continue to do so in the future.
- Demographic and technological changes interact with each other, meaning that the economic impacts of these two structural processes will be closely interrelated.
- The ageing of the Spanish working population has a negative impact on the rate of growth of the aggregate employment rate and productivity and, therefore, on potential economic growth.
- Population ageing also shapes labour demand through changes in household consumption patterns and the emergence of new activities related to the “silver economy”.
- Migration flows, the extension of working lives and education and labour market policies may help to reduce some of the adverse effects of population ageing.

The high unemployment rate and the technological and demographic change under way mean that labour market policies need an overhaul

- Labour market policy must be considered in its entirety. The ability of each instrument to efficiently meet its goals rests on the extent to which it complements the others.
- Active and passive labour market policies are a cornerstone of the welfare state. However, these policies have proven to be largely ineffective.
- The level of coverage/protection that passive policies afford the unemployed has been relatively low in Spain compared with other European economies. However, the unemployment benefit replacement rate is fairly high by international standards.
- When set against the unemployment rate, both the extent to which the unemployed participate in active policies and the amounts spent on such policies are low compared with other developed countries.
- In the light of the technological and demographic changes currently under way, which will lead to major shifts in the sectoral and occupational structure of employment, it is crucial to improve the performance of active and passive labour market policies.
- Other aspects of the institutional framework of the Spanish labour market should also be reconsidered to enable a smoother adjustment of labour supply and demand.
- Longer working lives should be encouraged by doing away with certain aspects that, in practice, serve to drive older workers out of the labour market.
- Collective bargaining should allow for a degree of flexibility to cater to firms’ individual circumstances.
- The regulations governing termination costs must ensure that workers are adequately protected, while at the same time facilitating mobility across sectors and occupations.
- The working week follows a downward secular trend and is set to continue declining.
- Any reduction to the statutory working week should take into account the considerable heterogeneity across the different types of firms and sectors and its effects on employment.

Chapter 4

The Spanish housing market: recent changes, risks and affordability problems

Robust housing demand, along with relative supply rigidity, has caused sustained growth in purchase and rent prices since 2014

- Housing purchases are remarkably robust, despite the slowdown observed since 2022 Q4, against a favourable macroeconomic backdrop and tighter financial conditions since early 2022.
- Demographic growth is a key factor in explaining the strong demand for both owner-occupied and rental residential housing.
- This population growth is largely explained by significant net external migration, which has intensified since 2022.
- Net household formation is concentrated in certain regions and in the main urban areas, where the highest house price and rent increases have been observed.
- The increase in the demand for a main residence has been accompanied by the strength of demand from non-residents, whether for owner-occupied or rental (but mainly holiday) housing.
- Recourse to mortgage financing for purchases has declined since the start of monetary tightening, although the number of new residential mortgages was higher in 2023 than in 2019.
- Banks seem to have maintained prudent credit standards when extending mortgage loans, thus avoiding the build-up of imbalances such as those that led to the 2008-2013 real estate and banking crisis.
- Prudent credit allocation in recent years, along with house price and labour market dynamics, have contributed to a notable shift in housing demand among the lower-income groups towards a rental market that is relatively small in the context of the EU-27.
- Despite the significant increase in the privately owned rental supply, it seems to have been insufficient to absorb the strength of demand, with a low proportion of professional agents and social rentals.
- The contribution of new housing to aggregate supply has been limited, owing to, among other factors, construction workforce shortages, rising production costs and a lack of investment to acquire and develop new urban land available for construction.
- Residential housing supply rigidity is also explained by the low house renovation capacity, empty houses not matching current household preferences, regulatory uncertainty and the rise of alternative housing uses, such as holiday or seasonal rentals.
- The lacklustre housing supply in the recent period, compared with the robustness of demand, has significantly underpinned house purchase and rental price growth.
- However, cumulative growth is uneven and stronger in new housing, large urban areas and tourist areas.

Despite the notable dynamism of residential housing market activity, the vulnerabilities and risks to financial stability associated with this market are contained

- There are no indications of the real estate market becoming oversized. The share of the construction sector in total employment and the ratio of residential investment to GDP are low by historical standards.
- Nor have any warning signs been observed in relation to the credit market. In general, credit standards related to collateral and maturity are at prudent levels.

- Indicators of loan repayment capacity based on borrower income also stand at prudent levels, although some deterioration has been observed in the most recent period.
- The latest data (for 2023 Q4), suggest that the average house price valuation indicator stands close to the equilibrium level.

Housing affordability difficulties have become more pronounced over the last few years, particularly for certain types of households and in certain geographical areas

- By cohorts, housing affordability poses greater challenges for lower-income households and those with scant saving capacity, groups that include a high proportion of young people and foreign residents.
- The housing affordability difficulties owe to property prices rising faster than these cohorts' income, which tends to be subject to more uncertainty due to their labour market situation.
- By geographical area, the difficulties are most acute in areas that are more economically buoyant and those with higher levels of tourism.
- The proportion of mortgaged households overburdened by their housing costs is low.
- The lesser burden on mortgaged households appears to reflect, at least in part, sound selective lending by banks, which only extend credit to households that have sufficient savings and income relative to the price of the property.
- By contrast, the percentage of renter households that are overburdened by their housing costs is very high, above the EU-27 average.
- Lower-income households, which cannot afford home ownership, face high rental costs relative to property prices. This partly owes to problems in the functioning of this market.

The adverse social and economic consequences of these difficulties warrant the adoption of economic policy measures geared to correct them

- Housing cost overburdening limits households' ability to save and may influence not only their consumption and investment decisions but also their decisions on where to live, whether to have children and whether to continue their education.
- In consequence, housing affordability problems may have both short and long-term negative implications and may give rise to lower aggregate productivity and lower economic growth.
- Considering the scale of the problem diagnosed here, it seems unlikely that isolated short-term actions may be sufficient to significantly reduce today's housing affordability difficulties.
- At the same time, public policies should be designed to ensure that actions that may have relatively limited effectiveness in the short term do not ultimately have significant unwanted effects that hinder the functioning of this market in the medium and long term.
- Insofar as today's housing affordability problems are the result of imbalances that have built up over many years, they must be addressed via a combination of multiple structural policies in different areas.
- In particular, the measures adopted should:
 - envisage a broad time horizon for design, implementation and evaluation of the public policies;
 - involve all the various tiers of government with responsibility for housing, in a coordinated manner and in collaboration with private initiatives;

- focus, in particular, on stimulating housing supply, especially in the rental market and social rentals, prioritising allocation of the available resources to the most vulnerable groups; and
- consider other aspects that affect the housing market, such as those relating to the functioning of the labour market, the strength of economic productivity and tax and transport policies.