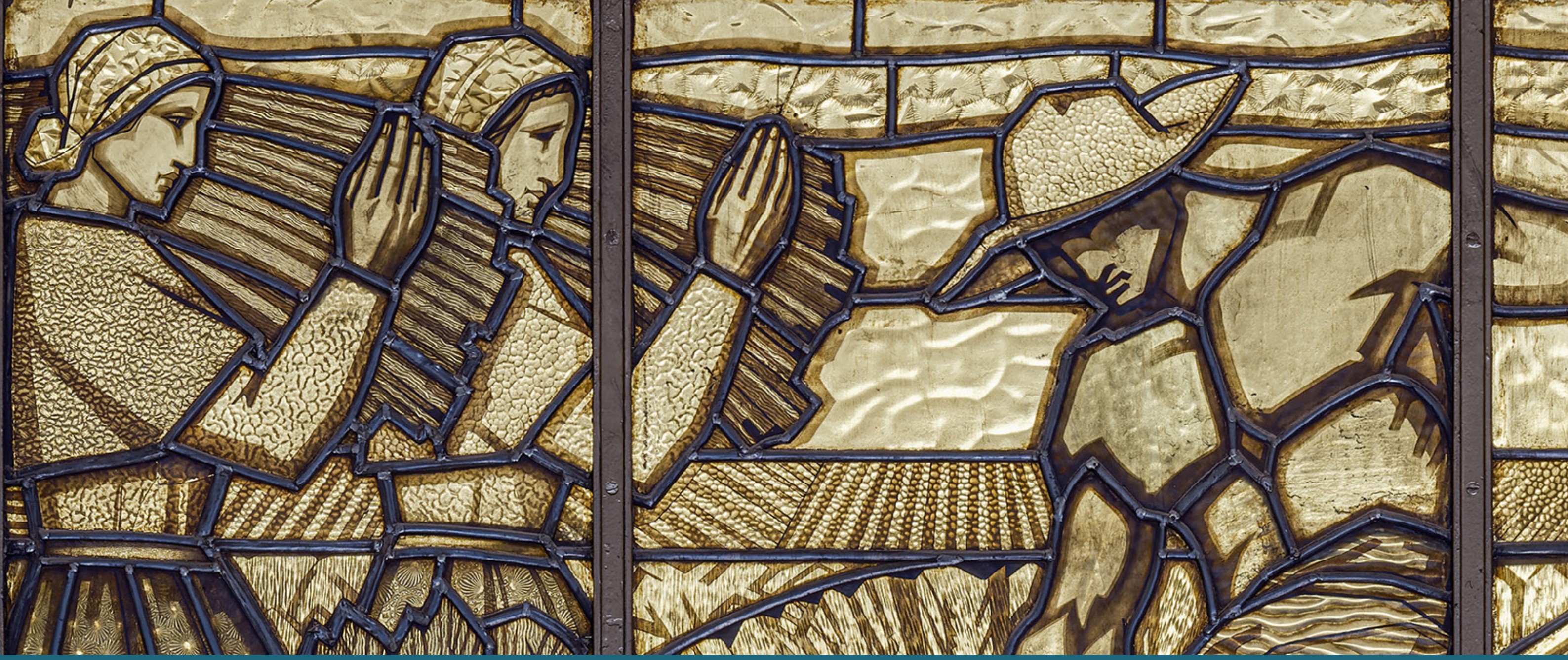
Chapter 1

The resilience of the Spanish economy in the European context

Banco de España
Annual Report 2023

Contents



Chapter 1
Takeaways

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

— The raising of the European Central Bank's 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 households' and firms' vulnerability and the credit quality of banks' balance sheets.

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

— 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.

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

1 Introduction

In 2023 and in 2024 to date, global economic developments have been shaped by the continuing decline in inflation. First, the sharper than initially expected falls in energy commodity prices and the gradual clearing of global trade bottlenecks following the pandemic have contributed to prices easing. Second, the tightening of global monetary policy into restrictive territory, where it remains, along with its pass-through to financing conditions, have also helped to lessen inflationary pressures.

Against this backdrop, while global economic activity slowed somewhat over the course of 2023, it remained stronger than initially expected, owing partly to the considerable vigour of labour markets in most global economies and, in some regions, to fiscal policy support. However, there was significant unevenness across regions, with, for example, the acceleration seen in the United States and China standing in contrast to the sharp slowdown (more marked than expected at the beginning of 2023) in the euro area, which was notably weak. Among the European countries, the German economy was particularly subdued and even contracted slightly.

Looking to 2024, global economic dynamism is expected to remain close to current levels, with growth rates relatively lacklustre by historical standards and varying across regions. Growth is expected to lessen slightly in China and other emerging economies, compared with a slight uptick in the case of the United States and the euro area, although the latter continued to be one of the regions with more subdued economic activity. Global inflation is expected to continue to slacken, albeit somewhat less so than in recent quarters. In line with this global economic outlook, the cumulative tightening of monetary policy helped to contain inflationary pressures, while still having a relatively limited cost in terms of dampening activity growth and the labour market. In this context, international financial markets anticipate that the central banks of the major advanced economies – including the European Central Bank (ECB) – will lower policy rates before long, having held them unchanged since 2023 H2.[1]

Activity in the Spanish economy has shown marked resilience in recent quarters, despite the tightening of financing conditions and muted activity in the euro area. In particular, the slowdown in GDP growth in 2023 as a whole was less marked than envisaged in the projections available at the beginning of the year (see Box 1.1). Moreover, GDP growth was significantly stronger in Spain than in the euro area as a whole, owing, at least in part, to the fact that Spanish GDP was further below its pre-pandemic level at end-2022 and because the impact of the energy crisis – linked to the Russian invasion of Ukraine – appears to have been less severe on the Spanish

1 A case in point is the Bank of Japan, which, at its March meeting, tightened its monetary policy stance by, among other things, choosing to raise interest rates (for the first time since 2007) into slightly positive territory (for the first time since 2016) and abandon its yield curve control strategy, which sought to keep long-term interest rates low. These decisions were taken in a setting in which, according to the Bank of Japan's Outlook for Economic Activity, published in January 2024, the price surge in recent years will be conducive to achieving the price stability target of 2% in a sustainable and stable manner towards the end of the projection period.

economy than on its European peers. Thus, at end-2023, GDP stood around 3% higher than at end-2019 in both Spain and the euro area, despite the Spanish economy's relatively sharper contraction during the pandemic. However, in an environment of high immigration flows over the last two years, Spanish GDP per capita was 0.3% above its end-2019 level, lagging behind that of the wider euro area, which stood 2% above its pre-pandemic level.

Buoyant government consumption and household spending, together with the robust performance of net exports, appear to have been the main drivers of activity in Spain, while business investment has been notably weak. First, household spending decisions appear to be underpinned by strong employment,[2] which, together with the slowdown in inflation, contributed to real income growth in a setting of population growth and widespread use of consumer credit. Second, despite the slowdown in the main Spanish export markets, net exports made a positive contribution to GDP growth in 2023, owing to the strength of international tourist arrivals in a context of very weak imports. Lastly, increases in firms' perceived uncertainty and tighter financing conditions appear to have had a negative impact on their investment decisions, despite rising profits. In any event, growth in household income and firms' profits appears to have mitigated the increase in households' and firms' vulnerability associated with the cumulative interest rate rises since 2021, while the non-financial private sector continued reducing its debt (see Box 2). In addition, private sector deleveraging and the increase in the current account surplus in 2023 led to a significant drop in Spain's negative net international investment position (IIP) vis-à-vis the rest of the world. However, the general government structural budget deficit is still expected to remain above that of 2019, while government debt remains high, at 107.7% of GDP at end-2023.

Looking ahead, the Spanish economy's growth outlook remains relatively favourable over the 2024-2026 horizon.[3] The progressive dissipation of the negative impact of monetary policy tightening on activity will contribute to the gradual revival of the European economy as a driver of external demand and growth in the Spanish economy. In addition, 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 domestic demand.

In any event, 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 persistent weaknesses in the Spanish economy in recent years. These include lacklustre productivity and high government debt and deficits (see Chapter 2 of this report), high structural unemployment in a context of significant labour market challenges related to population ageing and the digital transition (see Chapter 3 of this report), and mounting housing affordability difficulties faced by households (see Chapter 4 of this report).

2 For more details on recent developments in the Spanish labour market and its future challenges, see Chapter 3 of this report.

3 See Banco de España (2024d).

2 The global and euro area economic context

Falling energy commodity prices and the fading of previous years' adverse supply shocks influenced developments in the global economy in 2023.

— The sustained easing in commodity prices contributed significantly to the disinflationary process throughout 2023. In terms of energy commodities, the Brent oil price fell from its peak of $120/barrel in June 2022 to around $80/barrel at end-2022, hovering around that level throughout 2023, as anticipated by futures markets in early 2023.[4] In the case of natural gas, high European Union (EU) inventories, combined with an increase in non-Russian gas supplies, helped prices to fall from €75/MWh in January 2023 to €28/MWh at the end of the year, a significantly steeper drop than expected by futures markets at the beginning of the year (see Chart 1.1.a). Turning to agricultural commodities, prices also fell somewhat more sharply than was initially priced in by futures markets.

— In 2023 the progressive clearing of bottlenecks in global value chains and declining energy prices contributed to a marked slowdown in industrial goods prices. This easing of supply chain strains and industrial producer prices was also furthered by cooling demand for this type of goods, amid the ongoing shift in household consumption towards services. However, since mid-December 2023, tensions rising in the Middle East as a result of the war in Gaza have prompted fresh disruptions to international trade flows in the Red Sea, driving up shipping times and costs. So far, these disruptions have had a relatively limited impact on supply chain bottlenecks, according to the index developed by the Banco de España, which still stands below its all-time highs during the pandemic (see Chart 1.1.b).[5]

Economic activity was also affected by the tightening of monetary policy in the main advanced economies in 2022 and 2023.

— In the context of slowing global inflation (as discussed below), the central banks of the main developed economies continued to tighten their monetary policy throughout 2023, before pausing policy rate rises in H2. In particular, between January and September 2023, the ECB raised the deposit facility rate by 200 basis points (bp) to 4%, the Federal Reserve System raised its policy rate range by 100 bp to 5.25-5.50% and the Bank of England raised its bank rate by 175 bp to 5.25% (see Chart 1.1.c). Since then, the central banks of the major advanced economies have kept policy rates unchanged,[6] although global financial markets expect them to pivot to rate cuts in 2024.[7]

4 For more details on the drivers of oil price changes in 2023, see Alonso (2024).

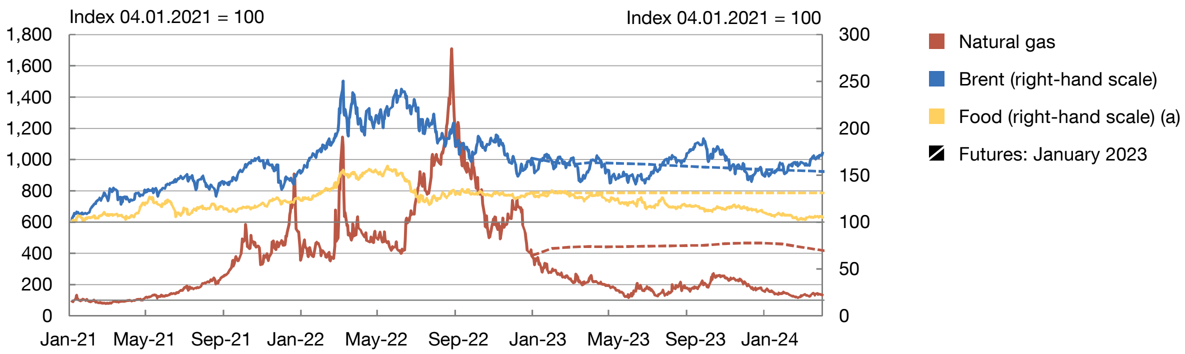
5 For an analysis of the impact of the Red Sea crisis on bottlenecks, see Viani (2024). For more details about the bottlenecks index, see Burriel, Kataryniuk, Moreno and Viani (2024).

6 The Bank of Japan was a notable exception. At its March meeting, it raised its rates for the first time since 2007, setting them above zero for the first time since 2016.

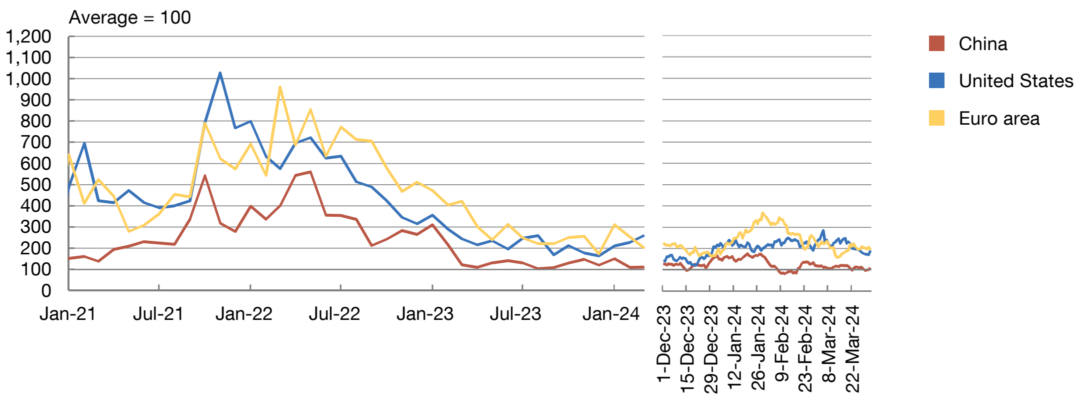
7 In this context, while the euro rose slightly against the US dollar in 2023, possible divergence in the speed of interest rate cuts may influence exchange rate developments in 2024.

Chart 1.1
Global economic activity was shaped by falling energy prices, clearing bottlenecks and tightening monetary policy

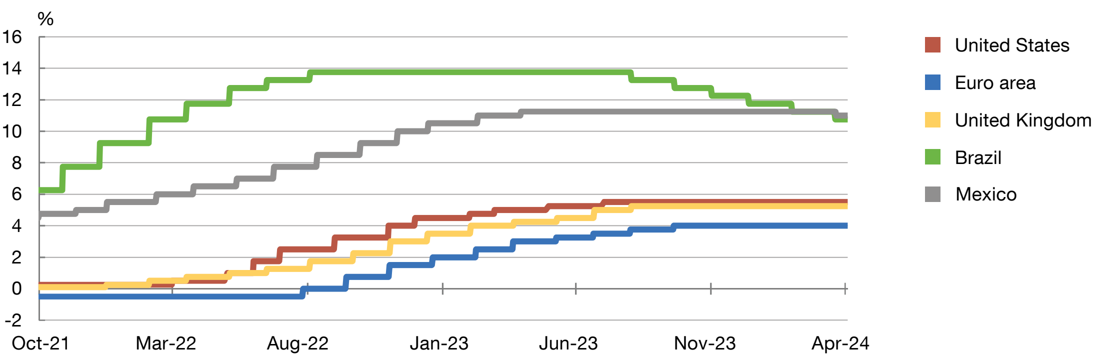
1.1.a Gas, oil and food prices



1.1.b Supply bottlenecks index: Red Sea crisis (b)



1.1.c Policy rates



SOURCES: Banco de España, drawing on Burriel, Kataryniuk, Moreno and Viani (2024), national statistics and Refinitiv.

a Bloomberg Agriculture Spot Index.
b The supply bottlenecks index measures the proportion of newspaper articles that report on supply problems and is indexed to 100 for the period ending in December 2021 (Burriel, Kataryniuk, Moreno and Viani, 2024). The euro area index is calculated as the average of the domestic German, French, Italian and Spanish indices.

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— In the case of the emerging market economies, which, broadly speaking, began monetary tightening earlier and more intensely, progress in the disinflationary process also allowed them to begin cutting policy rates earlier. For example, some central banks in Latin America and eastern Europe reduced their policy rates in 2023 H2.

Global economic activity slowed somewhat over the course of 2023, although it remained more dynamic than initially expected and was highly uneven across geographical areas, with particularly lacklustre economic growth in the euro area.

— The global economy grew by 3.2% in 2023, according to the April 2024 World Economic Outlook (WEO) published by the International Monetary Fund (IMF), below the 3.5% recorded in 2022. This slight slowdown in global economic activity was highly uneven across geographical areas, with the surge in the United States and China standing in sharp contrast to the pronounced slowdown in the United Kingdom and the euro area (see Chart 1.2.a).

— In the euro area, GDP growth eased significantly, falling from 3.4% in 2022 to 0.4% in 2023, well below the figure projected in early 2023. The marked weakness in the euro area as a whole masks considerable variation between the countries. There was particularly pronounced fragility in central and northern Europe, with GDP falls in Austria, Finland and Germany, among others, with the latter being especially noteworthy given its large share of euro area GDP. Elsewhere, other major economies, such as France and Italy, saw growth rates slow, standing just under 1% throughout 2023. Lastly, some countries in southern Europe, such as Spain, Greece and Portugal, enjoyed stronger growth, of around 2%, although this too was below that of 2022.

— Such unevenness in the pace of deceleration within the euro area can be explained, at least in part, by the varying impact of the war in Ukraine. In particular, higher energy prices appear to have had a negative impact on all economies, but more so in those that are more dependent on commodities from Russia and in which energy-intensive industries account for a greater share of production, such as Germany. Other determinants in the slowdown in economic activity throughout the euro area include the impact of the cumulative tightening of monetary policy and its pass-through to the real economy, and the decline in confidence.

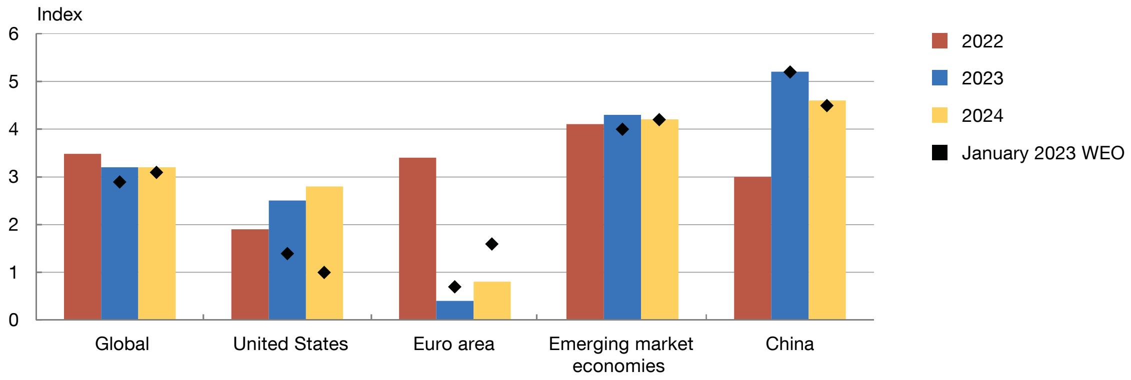
— Activity picked up in the United States, with GDP growth at 2.5% in 2023, above the 1.9% of 2022 and higher than forecast in early 2023. This mainly owed to strong domestic demand, both from private consumption and investment, which was itself driven by the labour market's resilience, the expansionary fiscal policy stance and greater use of savings buffers built up during the pandemic.[8]

— Developments were also uneven in other developed economies. UK GDP growth rates fell from 4.3% in 2022 to 0.1% in 2023 as a result of, among other factors, high inflation and the

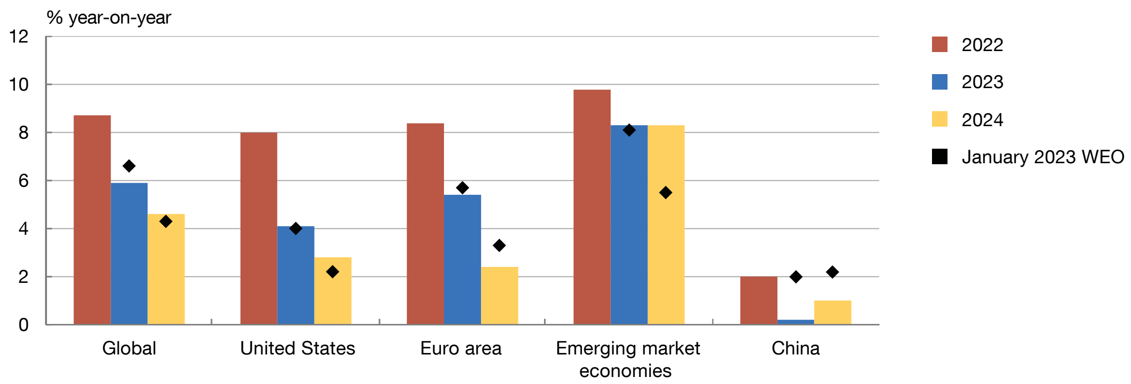
8 For a comparative analysis of the use of savings buffers, see, for example, de Soyres, Moore and Ortiz (2023).

Chart 1.2
Global economic activity slowed somewhat in 2023, albeit with marked unevenness across regions, as headline inflation continued to fall

1.2.a GDP growth: actual and WEO forecasts (a)



1.2.b Inflation: actual and WEO forecasts (a) (b)



SOURCES: IMF (WEO January 2023, WEO April 2023 and WEO April 2024) and national statistics.

a Final figure for 2022, other values are forecasts
b The forecasts for China are those of the WEO (April 2024 and April 2023).

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tight monetary policy stance intended to curb it. In Japan, growth in activity rose from 1.0% in 2022 to 1.9% in 2023, against a backdrop of a more expansionary economic policy stance.

— With regard to emerging market economies, there was a noteworthy uptick in the case of China, where GDP grew by 5.2% in 2023 (outstripping expectations), compared with 3% in 2022. In any event, following the pick-up in growth at the beginning of 2023 as the Chinese economy reopened, activity slowed substantially in Q2 (mainly as a result of the real estate crisis)[9] before stabilising in H2 on the back of economic policy support and strong consumption. In addition, the risks associated with real estate market developments

9 See Banco de España (2023c) and Alonso, Santabárbara and Suárez-Varela (2023).

remain significant, as demonstrated by the liquidation of Evergrande, the real estate developer, in late January 2024, although contagion to other institutions has not yet been observed.

— Latin America saw a downturn in activity – from 4.2% in 2022 to 2.5% in 2023 – that was less severe than expected at the beginning of 2023. In particular, the relative buoyancy of the region's two largest economies, Brazil and Mexico, which grew faster than expected at the beginning of the year, stood in contrast to weaker than expected growth in the rest of the region.[10]

Looking ahead, the forecasts available envisage global economic growth steadying somewhat, albeit with marked unevenness across regions.

— In early 2024, the indicators point to a stabilisation in the pace of global economic growth, although significant variation across regions remains, both in terms of recent performance and future outlook, according to the latest forecasts available.

— The March 2023 ECB staff macroeconomic projection exercise points to a slight uptick in euro area GDP in 2024, as a result of the increase in real disposable income amid rising wages and easing inflation. By contrast, investment is expected to contract in 2024 as a result of the negative impact of tight financial conditions. However, a subsequent recovery is expected, driven by the gradual easing of these conditions and the roll-out of NGEU-funded projects.

— In the case of the United States, according to the IMF April 2024 WEO, overall GDP growth is expected to accelerate slightly in 2024 to 2.7%, compared with 2.5% in 2023, owing to resilient domestic demand and the carry-over effect of the momentum seen in late 2023, despite the cumulative effects of tight monetary policy and less expansionary fiscal policy.

— Among emerging market economies, the latest IMF projections indicate a notable slowdown in the Chinese economy, while activity growth in Latin America is expected to stabilise somewhat, at rates similar to those recorded in 2023 (except in Argentina, where a decline is projected).

Global headline inflation rates have been falling, although underlying inflation has done so more slowly.

— Headline inflation generally moderated worldwide over the course of 2023, from an average of 8.9% in September 2022 to 4.2% in December 2023. Underlying inflation also eased globally, from 6.7% in October 2022 to 4.8% in December 2023, albeit with greater downward stickiness and more slowly (see Chart 1.2.b).

10 See Banco de España (2024a).

— Despite inflation easing significantly, it remained high across the different regions. In the euro area, headline inflation dropped from a high of 10.6% in October 2022 to 2.9% in December 2023, while underlying inflation eased from 5.7% in March 2023 to 3.4% in December.[11] In the United States, headline inflation subsided from its peak of 9.1% in June 2022 to 3.4% in December 2023, while underlying inflation reduced from 6.6% in September 2022 to 3.9% in December 2023. In Latin America, the average inflation rate decreased from 10.2% in June 2022 to 5.0% in December 2023, although underlying inflation was more downwardly sticky. In China, by contrast, inflation remained much lower than in other areas and subsided over the course of 2023, to stand at -0.3% in December 2023, owing mainly to falling food prices.

— Alongside softening energy prices and, to a lesser extent, the impact of monetary policy tightening, other factors contributed to a broad-based reduction in inflation rates worldwide. These notably include the base effects in 2023 following the price upsurge of 2022 and, in some regions, such as the euro area, the fiscal measures approved to contain inflation. Nonetheless, the temporary nature of these phenomena suggest that inflation will drop more slowly in the future, as envisaged in projections.

— Early inflation data for 2024 have been generally characterised by downward surprises in the energy component (although smaller than those recorded in early 2023) and by a certain downward stickiness in services inflation.

— Going forward, inflation is expected to continue to moderate across all regions, albeit somewhat less rapidly than in recent quarters. In any event, in both the euro area (in line with the March 2023 ECB staff macroeconomic projection exercise) and in the United States (according to the Federal Reserve System’s projections) headline inflation is expected to reach the 2% target level around 2025 H2 and to remain around that figure in 2026.

11 The decline in headline inflation was particularly steep in Italy, Belgium and the Netherlands (with rates below 1% in December 2023), while it was more moderate elsewhere, such as in France, where it ended the year above 4%.

3 ECB monetary policy and its pass-through to financing conditions

The ECB continued raising its key interest rates up to September 2023, when the deposit facility rate reached 4%, and has kept them unchanged since then.

— In line with its data-dependent approach, the ECB slowed the pace of the hikes to its key interest rates as inflation expectations gradually re-anchored towards the target of 2% over the medium term. After raising interest rates by a cumulative 250 bp in 2022, the ECB increased rates by 50 bp on two further occasions (in February and March 2023) and then by a more moderate 25 bp at each of the following four meetings (see Chart 1.3).

— The ECB has kept its key policy rates unchanged since September 2023, once it considered that they were at levels that, if maintained for a sufficiently long duration, would contribute to the return of inflation to its 2% medium-term target.

— More recently, at its April meeting the Governing Council stated that it would be appropriate to reduce the current level of monetary policy restriction if its updated assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission were to further increase its confidence that inflation was converging to the target in a sustained manner. In any event, future decisions will continue to follow a data-dependent approach and the ECB is not pre-committing to a particular rate path.

The ECB also continued to reduce the size of the Eurosystem's balance sheet throughout 2023.

— First, the balance sheet[12] continued to shrink via repayments of amounts borrowed in the third series of targeted longer-term refinancing operations, such that the stock of these operations has fallen by €2.1 trillion since it peaked in late 2021.

— Second, the ECB has also started to reduce the asset purchase programme (APP) portfolio. From March 2023 the ECB only partially reinvested the principal payments at an average run-off pace of €15 billion per month[13] and had discontinued such reinvestments as of July 2023. Overall, the APP portfolio has decreased by more than €248 billion since March 2023. More recently, in December 2023 the Governing Council announced that it would also start to reduce the pandemic emergency purchase programme (PEPP) portfolio over the second half of 2024.[14]

— Lastly, on 13 March, the Governing Council announced the outcome of the review of the ECB's operational framework.[15] Under the new framework, the Governing Council will

12 For a more detailed explanation of a central bank's balance sheet and the implications of its shrinking, see Nuño (2024).

13 Specifically, holdings of securities acquired under the APP were reduced by €15 billion per month up to July 2023.

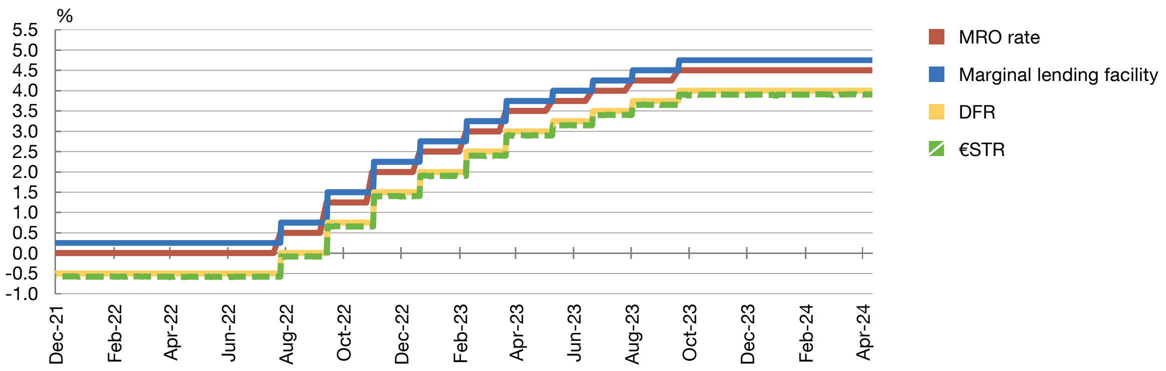
14 The ECB intends to start reducing the PEPP portfolio by €7.5 billion per month on average in July 2024 and, as previously announced, to discontinue reinvestments under the PEPP at the end of 2024.

15 The ECB's operational framework steers short-term money market rates to the levels desired by the Governing Council. For further information on the announced changes to the ECB's operational framework, see ECB (2024).

Chart 1.3

The ECB gradually slowed the pace of the increases in its key interest rates over the course of 2023 until they reached 4% in September, keeping them unchanged since then

1.3.a Key ECB interest rates and the euro short-term rate (€STR)



SOURCES: Banco de España and Refinitiv Datastream. Latest observation: 11 April 2024.

continue to steer its monetary policy stance by adjusting the deposit facility rate (DFR).[16] However, the spread between the DFR and the rate on the main refinancing operations (MROs) will be reduced from 50 bp to 15 bp as from 18 September, with a view to limiting the volatility of market rates. In addition, the Eurosystem will reduce its footprint in the market by providing liquidity to the system through a variety of instruments based on banks' demand for reserves.[17] In any event, the Governing Council will remain vigilant throughout the transition to a system with less abundant reserves and will review the parameters of its operational framework in 2026 or earlier if necessary.

Interbank rates continued to rise in 2023. The increases gradually eased in Q4 as the change in monetary policy expectations took hold, but picked up slightly in early 2024, standing at levels below the peak values of 2023.

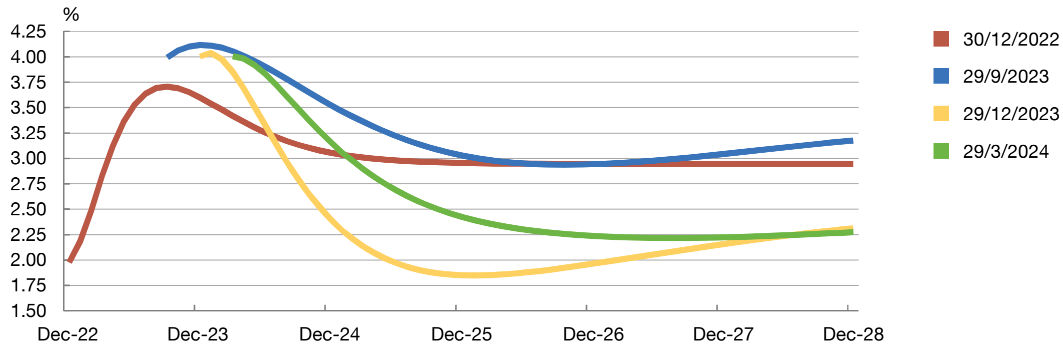
— Financial market expectations shifted in 2023 Q4, envisaging the first policy interest rate cuts being brought forward and lower interest rate levels over the coming years (see Chart 1.4). Despite being revised upwards in early 2024, interest rate expectations remained short of the levels seen in 2023. Meanwhile, the increase in uncertainty over the future path

16 Although media coverage typically singles out the MRO rate, in recent years the DFR has been the key ECB interest rate to which rates in the interbank market and, therefore, in the credit market for consumers and firms, have been more closely linked. For more details, see Martínez-Martín (2023).

17 In particular, the Eurosystem will provide liquidity through a broad mix of instruments, including short-term credit operations and three-month longer-term refinancing operations as well as – at a later stage – structural longer-term credit operations and a new structural portfolio of securities (which will factor in climate-change considerations in line with the ECB's secondary objective of supporting the EU's general economic policies).

Chart 1.4
Financial market expectations shifted in 2023 Q4, envisaging the timing of the first policy interest rate cuts being brought forward

1.4.a Adjusted €STR OIS instantaneous forwards (a)



SOURCES: Refinitiv Datastream and Banco de España.

a Instantaneous forward rates estimated based on market data on OIS rates at different maturities using the Svensson (1994) parametric model and adding the spread between the DFR and the €STR on the estimation date.

of interest rates[18] in 2023 Q4 corrected in the first months of 2024, to stand well below the historically high levels of late 2022.

— In line with the changes in market rate expectations throughout 2023, the 3-month EURIBOR, which typically serves as the reference rate in short-term and floating-rate financing extended to firms, increased by 187 bp between late 2022 and mid-October 2023. Since then it has fallen slightly, by 11 bp, to 3.9% at end-March 2024.

— Meanwhile, the 12-month EURIBOR, the main reference rate for floating-rate mortgages, rose by 94 bp between late 2022 and end-September 2023. However, since then, it has fallen by 56 bp, to 3.7% at end-March 2024.

— The ten-year swap rate, which is typically used as the reference rate for households' and firms' long-term fixed-rate financing, rose by 32 bp between late 2022 and early October 2023. Since then it has fallen by 95 bp, to stand at 2.6% at end-March 2024.

The cost of new financing to households and firms increased in 2023. However, these rises tapered off in the second half of the year, and even reversed in Q4.

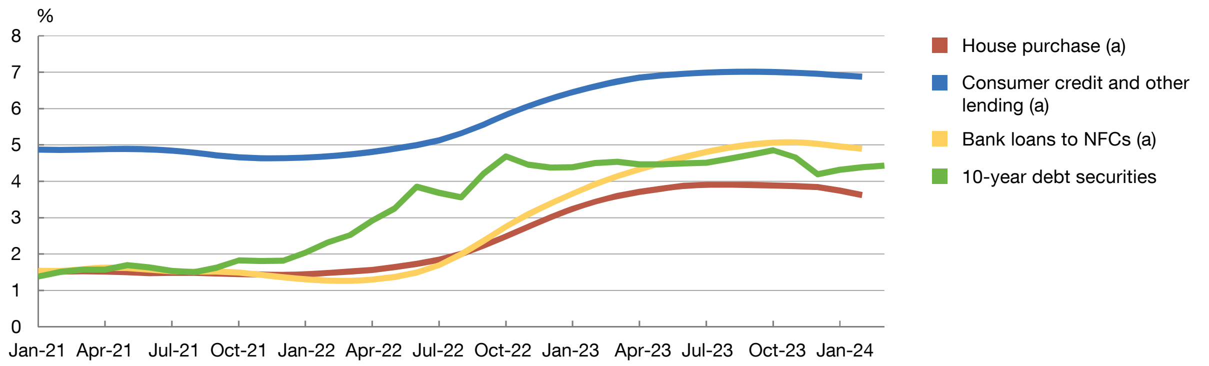
— In the first nine months of 2023, interest rates on new lending to households increased by 90 bp, to 3.9%, in the loans for house purchase segment and by 75 bp, to 7%, in the consumer credit and other lending segment. Subsequently, they fell by 28 bp and 14 bp,

18 Measured on the basis of the normalized volatility of at-the-money three-month options whose underlying assets are one-year interest rate swaps that have the 3-month EURIBOR as the floating rate.

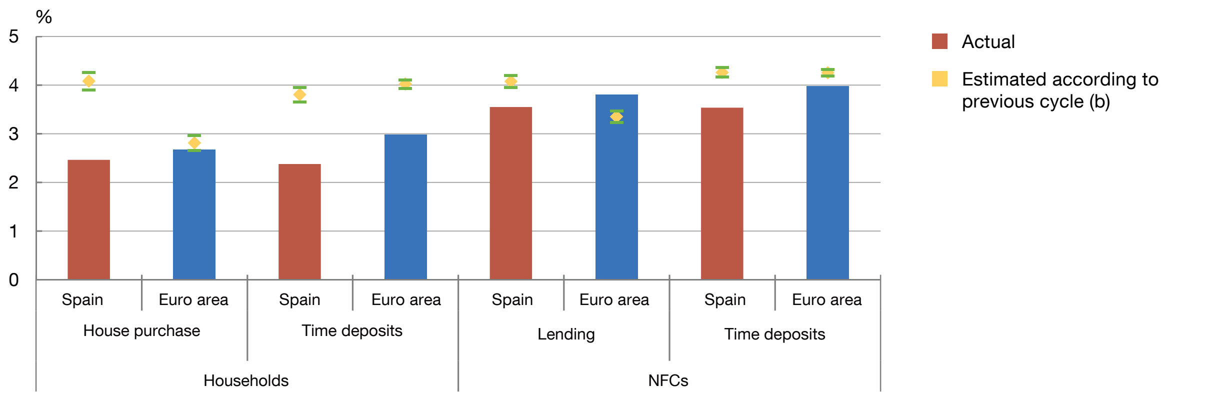
Chart 1.5

The increase in the cost of new lending eased in 2023 H2. The cumulative increase between December 2021 and October 2023 was smaller in Spain than in the euro area and smaller than suggested by historical regularities

1.5.a Cost of new lending to households and NFCs



1.5.b Cumulative change in bank interest rates between December 2021 and October 2023 (a)



SOURCES: ECB and Banco de España.

a Bank interest rates are narrowly defined effective rates, i.e. they exclude related charges, such as repayment insurance premia and fees. In addition, they are trend-cycle rates, i.e. they are adjusted seasonally and for the irregular component (small changes in the series without an identifiable regular pattern or trend).

b Resulting bank interest rate if the current cycle's increase in the market interest rate had been passed through similarly to the previous cycle, according to standard error-correction models estimated for the period between January 2003 and August 2007. A model is estimated for short-term interest rates (up to one year) and long-term interest rates (more than one year). The chart depicts the composite interest rate, weighted by the volume of new lending.

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respectively, to stand at 3.6% and 6.9%, respectively, in February 2024. Interest rates on new lending to firms rose by a cumulative 151 bp, to 4.9%, between late 2022 and February 2024 (see Chart 1.5.a).

— Meanwhile, the cost of capital market-based funding for firms (ten-year corporate bond yields) increased by 47 bp between late 2022 and October 2023 and subsequently fell by 43 bp, to stand at 4.4% in March 2024.

The cumulative increase in interest rates on new lending and deposit rates in Spain 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.

— Between late 2021 and October 2023, interest rates on new lending in Spain increased by 246 bp, 237 bp and 355 bp in the households for house purchase, consumer credit and other lending and loans to businesses segments, respectively. Broadly speaking, these increases were smaller than those observed on average in the euro area (see Chart 1.5.b). Interest rates on lending in Spain have fallen across all segments since October 2023 and, in February 2024, they stood at levels slightly below the euro area average in most segments.

— The cumulative increase in interest rates on new lending in Spain during the current monetary policy tightening cycle has been smaller than the historical patterns would suggest, given the increase in policy rates. This smaller pass-through has been particularly marked in the case of loans for house purchase (between December 2021 and October 2023 the interest rates on the loans increased by 1.6 pp less than expected on the basis of historical regularities), while these differences have been less pronounced in loans to businesses (0.5 pp less than expected on the basis of historical regularities). These developments in Spain stand in contrast to those in the euro area as a whole, where the increases have been in line with historical regularities or even exceeded them, as in the case of financing granted to non-financial corporations (NFCs) (see Chart 1.5.b).

— The weaker pass-through of the increase in policy rates to the interest rates on new lending in Spain could be related to some of the idiosyncrasies of the banks and the pass-through to deposit rates. According to the findings of a recent Banco de España paper (Mayordomo and Roibás, 2023), Spanish banks have passed through the interest rate hikes to their deposit rates less forcefully mainly because they have less need to raise funds via deposits in order to lend and, to a lesser extent, due to the higher level of concentration. In turn, those banks that have recorded smaller growth in their overall deposit rates have passed through to a lesser extent the increase in market interest rates to their lending rates, particularly mortgage rates.[19] Thus, the lower costs of funds raised via deposits, which are Spanish banks' main source of funding, appear to have resulted in lower interest rates on lending than in the rest of the euro area.

Loan supply and demand in Spain continued to contract in 2023, in both the lending to businesses and the lending to households segments.

— According to the Bank Lending Survey (BLS), credit standards and the overall terms and conditions for new loans in Spain have tightened steadily since mid-2022.[20] However, since 2023 Q4 loan supply has ceased to tighten in most segments (see Chart 1.6). In addition, the Survey on the Access to Finance of Enterprises (SAFE) in the euro area shows that since

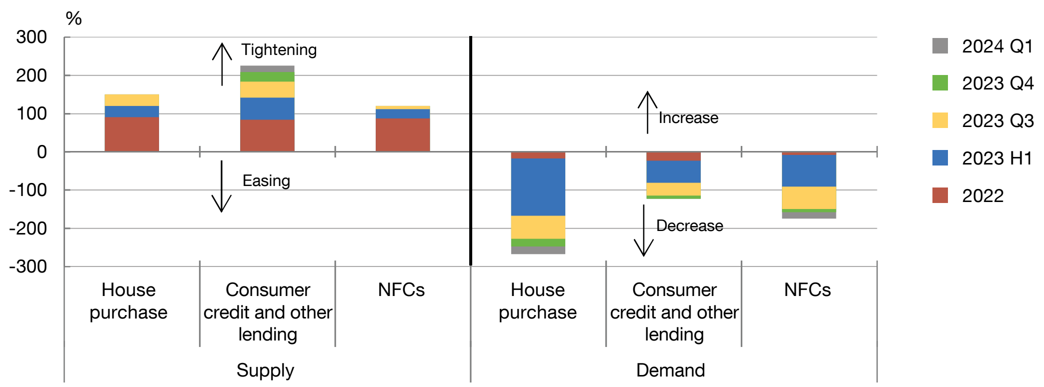
19 For more details on the possible determinants of the differences between Spain and the euro area in the speed of the pass-through of market rates to bank interest rates, see Mayordomo and Roibás (2023).

20 Changes in credit standards for consumer credit and other lending could reflect the tightening of the credit standards for other (non-consumer) lending, which contracted during 2023 due to the fall in lending to sole proprietors. Conversely, consumer credit has recorded positive year-on-year growth rates and strong momentum during the monetary tightening cycle, which appear to be associated with the financing of durable consumption.

Chart 1.6

Loan supply and demand in Spain continued to contract in 2023, although in Q4 loan supply ceased to do so in most of the segments

1.6.a Cumulative change in credit standards and demand for bank loans in Spain. BLS (a)



SOURCES: ECB and Banco de España.

a Percentage of banks reporting a tightening (increase in the case of demand) less percentage of banks reporting an easing (decrease in the case of demand).

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April 2022 Spanish small and medium-sized enterprises' (SMEs) perceptions of the availability of bank credit have deteriorated.

— In both Spain and the euro area, banks' credit standards have tightened much more markedly than in the monetary tightening cycle of 2005. According to banks' responses to the BLS, the differences compared with 2005 are explained by their greater risk perception, which is consistent with the importance of the negative supply shocks in the current inflationary episode, unlike the positive demand shocks that prevailed during the monetary tightening cycle of 2005.

— The BLS shows that loan demand fell in Spain in 2023, particularly steeply in the loans to households for house purchase segment, and has continued to do so in early 2024. Demand fell in Spain and the euro area mainly because of higher interest rates. Lower consumer confidence and the deterioration in housing market prospects also exerted downward pressure on loan demand from households. Lower fixed investment did so in the case of firms. Meanwhile, data from the SAFE also reflect a drop in loan demand from firms throughout 2023 and in 2024 Q1, with the percentage of SMEs applying for bank loans reaching its lowest level since the survey began in 2009.

The outstanding amount of financing to firms and loans to households for house purchase continued to decrease in 2023, while that of consumer credit continued to rise.[21]

21 For more details on the factors behind these lending developments, as well as for more information on the uneven behaviour across different household segments, see Banco de España (2024c).

— The contraction in the stock of lending to firms in Spain ramped up throughout 2023, with October seeing the highest year-on-year decline since early 2015 (close to 5%). However, more recently, the pace of the decline has slowed and, in February 2024, the stock contracted by 3.4%. The transmission of monetary policy to the net flows of lending has been stronger than in the past, according to the negative surprises estimated by credit forecasting models.[22] A similar moderating profile has been observed in the euro area, albeit starting from higher growth rates and with the outstanding amount of credit not recording a year-on-year contraction until September.

— The financing obtained by firms through debt securities also continued to decline throughout 2023 in Spain, although in the final months of the year the pace of the year-on-year decrease eased and in the first months of 2024 the declines amounted to less than 1%. No year-on-year declines have been recorded in the stock of this type of financing in the euro area, although its pace of growth has slowed.

— The stock of mortgage lending continued to contract in 2023, albeit more moderately in recent months. This was due to the sluggishness of new mortgage lending and high repayments, the result of the incentives to pay down floating-rate mortgages against the backdrop of higher reference interest rates. In the euro area, the year-on-year growth rate of outstanding mortgage credit slowed in 2023 and fell slightly in early 2024.

— Consumer credit recorded notable growth, associated with the financing of durable goods (e.g. cars) purchases. This pattern is similar to that observed for the euro area. Meanwhile, the contraction in other lending to households intensified because of the fall in loans to sole proprietors.

— The decline in the outstanding amount of financing obtained by households and firms, together with the growth in nominal income, helped lower the debt ratios of both institutional sectors, which stood at levels close to those seen at the start of the 21st century and below those recorded in the euro area. Specifically, in 2023 Q4 those ratios stood at around 65% and 47% of GDP for firms and households, respectively, 3 pp and 7 pp below the ratios observed in the euro area as a whole (see Chart 1.7).

Since the monetary tightening cycle was launched in July 2022, Spanish banks' net interest income has increased considerably[23] and the credit quality of their balance sheets has deteriorated marginally.

— Consolidated net interest income grew by 37.1% in 2023 compared with the annualised figure for 2022 H1. This was because the increase in key policy rates has so far been passed through more forcefully to bank assets – dominated by floating-rate loans – than to bank

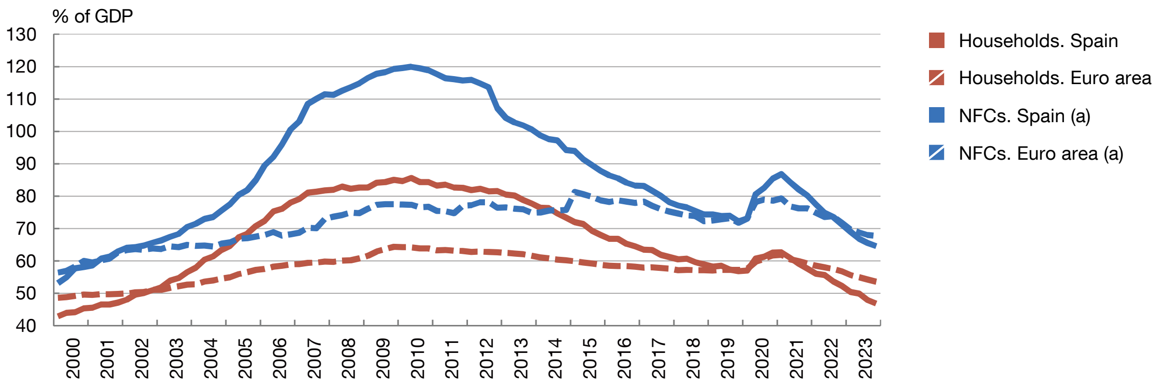
22 These surprises could be related to possible non-linearities in the transmission of monetary policy to credit supply. Indeed, according to García-Posada and Paz (2024), the speed and forcefulness of the increases in interest rates since 2021 have resulted in credit standards tightening more than in other monetary policy tightening episodes.

23 Banco de España (2023a).

Chart 1.7

Households' and firms' debt ratios continued to fall and now stand at levels close to those of the start of the 21st century and below those in the euro area

1.7.a Debt ratio of households and NFCs



SOURCES: ECB and Banco de España.

a Excludes debt positions between NFCs.

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liabilities.[24] The importance of retail deposits and a favourable liquidity position have helped contain Spanish banks' cost of liabilities.

— In 2023 the reduction in the stock of lending to the resident private sector tempered – by approximately 6 bp – the growth in the ratio of net interest income in business in Spain to the total assets of Spanish banks in June 2022. In addition, the debt security holdings on banks' balance sheets before the rate hiking cycle was launched have seen a drop in value; this has particularly affected those banks with a higher proportion of this type of asset carried at fair value. Meanwhile, at consolidated level impairment losses increased year-on-year by 22.9% in 2023, mainly because of business abroad (although they also rose in business in Spain).

— The non-performing loan (NPL) ratio and the stage 2 loan ratio for bank lending to the Spanish private sector as a whole stood at 3.4% and 7.6%, respectively, in December 2023. These levels are similar to those recorded 12 months earlier in the case of NPLs and slightly higher (0.5 pp) in the case of stage 2 loans. Broken down into households and firms, the asset quality of both loan portfolios has deteriorated, albeit very moderately.[25] In line with these developments, the higher cost of new lending to households and firms has also had a limited impact on their vulnerability (see Box 1.2).

24 In December 2023 Spanish banks' average cost of liabilities amounted to 2.6%, 1.9 pp higher than in June 2022, just before policy interest rate hiking began.

25 In the case of lending to households, the NPL ratio rose by 0.1 pp, to 2.9%, between December 2022 and December 2023, while the stage 2 loan ratio increased by 0.7 pp, to 6.1%, in the same period. NFCs' NPL ratio fell slightly (by 0.1 pp, to 4.6%) between December 2022 and December 2023. However, in the same period the stage 2 loan ratio rose by 0.4 pp, to 10.1%.

— Overall, net interest income growth dominated the changes in other income statement headings and prompted very favourable developments in Spanish banks' profitability in 2023. Return on assets and return on equity stood at 0.8% and 12.4% in 2023, 15 bp and 230 bp, respectively, higher than at end-2022.

— However, banks have not used the growth in profitability to significantly bolster the sector's solvency: the CET1 ratio stood at 13.2% at end-2023, only 17 bp above its 2022 level.

— Looking ahead, the impact of higher interest rates on bank profitability could be slightly less favourable than observed to date. Thus, net interest income should moderate once the interest rate hiking cycle is complete, as the increase in the cost of liabilities lags slightly behind that in interest income.[26]

— In addition, the materialisation of adverse macroeconomic scenarios marked by lower activity growth rates and/or higher-for-longer interest rates that could result in a further slight deterioration in credit quality cannot be ruled out.[27]

— The latest stress tests show that the Spanish banking sector's overall resilience is high.[28] However, in a highly uncertain environment with risks to growth that remain tilted to the downside, banks are still recommended to use some of the improvement in profitability to buttress their capacity to absorb future losses via provisioning and capital policies.

26 Evidence from prior periods shows that higher net interest income stemming from increases in policy rates tends to be time-limited (Pérez-Montes and Ferrer, 2018).

27 For more details on these risks and on bank profitability and solvency, see Banco de España (2024b).

28 See Banco de España (2023a) and Banco de España (2023d) for a summary of the results of Spanish banks in the Banco de España's Forward Looking Exercise on Spanish Banks and in the European Banking Authority's 2023 test.

4 The Spanish economy

In a context characterised by tighter financing conditions and the slowdown in euro area activity, economic growth in Spain has shown remarkable resilience in recent quarters – compared with both the forecasts available at the start of 2023 and the rest of the euro area – although per capita growth has been more modest.

— Over the course of 2023 the Spanish economy was affected by various constraints, including the growing impact of the cumulative tightening of financing conditions and the marked economic slowdown in the euro area. The petering out of the momentum resulting from the reopening of the economy after the pandemic also contributed to the slowdown in activity in Spain. Thus, the pace of GDP growth slowed in 2023, falling from 5.8% in 2022 to 2.5% in annual average terms.

— The GDP growth rate in 2023 was well above the Banco de España and analysts' consensus forecasts made at the beginning of the year. Two of the factors that contributed to this discrepancy are the positive carry-over effect on the 2023 average growth rate of the revised National Accounts released in September[29] by the National Statistics Institute (INE) and the stronger than initially expected growth of private consumption, government consumption and travel services exports – against a background in which migration flows and population growth grew faster than initially expected (see Box 1.1).

— GDP also grew faster in Spain than in the euro area, which saw GDP growth of 0.4% in 2023, below both the figure for 2022 (3.4%) and the forecast in the March 2023 ECB staff macroeconomic projections exercise (1%).

— Considering a longer time frame, GDP at end-2023 was approximately 3% above its end-2019 level in both Spain and the euro area as a whole, even though the decline during the pandemic was more pronounced in Spain. However, GDP per capita in Spain was barely 0.3% above its end-2019 level, well below the figure for the euro area as a whole, where it was 2% above its pre-pandemic level (see Chart 1.8).

The greater buoyancy of economic activity in Spain compared with the euro area as a whole over the course of 2023 was mainly due to a stronger boost from domestic demand and greater resilience to the energy shock.

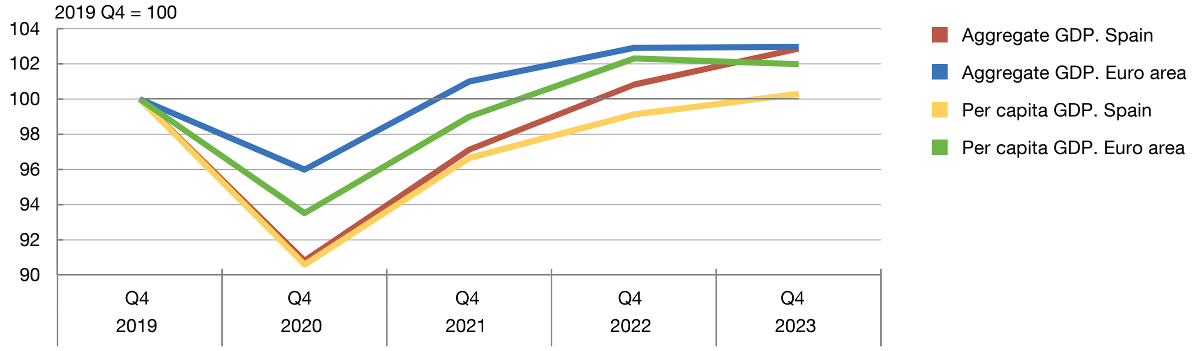
— The determinants of the differences in growth between Spain and the euro area over the course of 2023 can be identified using an econometric model that distinguishes between demand shocks (e.g. shocks to fiscal policy or agents' spending decisions) and supply shocks (e.g. shocks to productivity or to international commodity prices, such as energy

29 Fernández, González Mínguez, Izquierdo and Urtasun (2023).

Chart 1.8

Economic growth in Spain, which was greater on aggregate than in per capita terms, has shown some resilience in recent quarters and has been stronger than in the rest of the euro area

1.8.a Aggregate and per capita GDP in Spain and the euro area



SOURCES: INE and Eurostat.

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prices). This model also differentiates between domestic and international shocks, based on the fact that international prices are set on global markets and are therefore not immediately affected by developments in domestic variables.[30]

— The results obtained with this modelling strategy suggest that more than one-half of the difference in GDP growth between Spain and the euro area in 2023 is due to domestic demand shocks (see Chart 1.9.a).

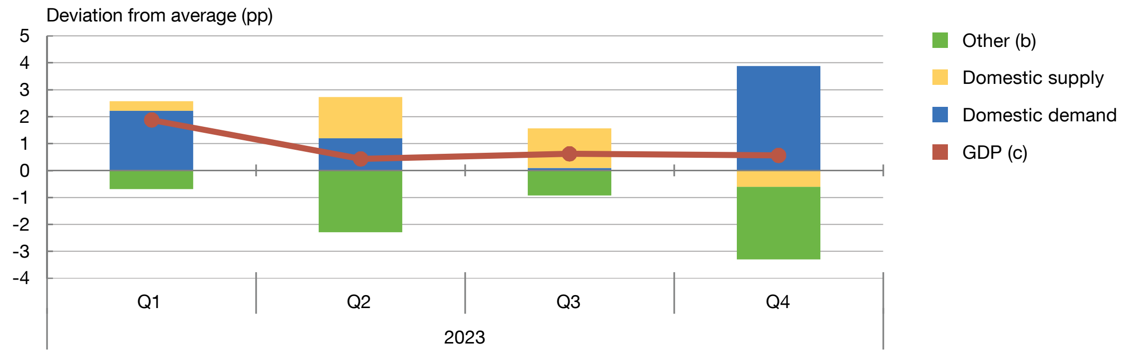
— As discussed below, the importance of domestic demand factors is consistent with the buoyancy of household consumption in Spain in 2023, among other developments. Specifically, compared with the rest of the euro area, the boost provided by the convergence of household consumption to its pre-pandemic levels appears to have been stronger in Spain, as it was the euro area country with the largest negative gap between consumption in 2022 and in 2019 (see Chart 1.9.b).

— It is also worth noting the remarkable dynamism of government consumption in Spain over the past year, in contrast to its sluggishness in the euro area. In 2023 real government consumption increased by 3.8% in Spain, compared with 0.7% in the euro area as a whole.

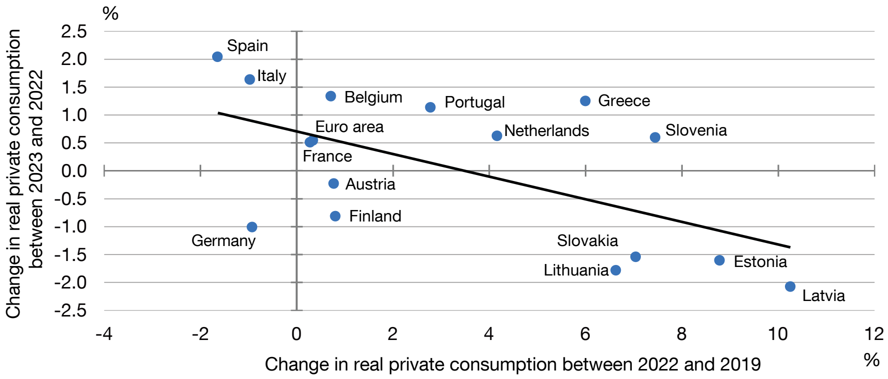
30 In particular, a macroeconometric structural vector autoregression model is considered similar to that used in Leiva-León, Martínez-Martín and Ortega (2022), estimated from a sample covering the period 2002-2023 for each area considered. The model uses sign restrictions to estimate the contribution of the demand and supply shocks, under the assumption that demand shocks drive economic activity in the area under consideration and prices in the same direction while supply shocks drive them in opposite directions. In addition, national and international price series are used to distinguish between shocks originating abroad – which affect all variables in the model contemporaneously – and domestic shocks – which only affect domestic variables.

Chart 1.9
The Spanish economy grew at faster rates than the euro area in 2023, mainly because of domestic supply and demand factors

1.9.a Difference in growth between Spain and the euro area (a)



1.9.b Private consumption growth in 2023 versus the consumption gap in 2022 with respect to pre-pandemic levels



SOURCES: Eurostat and Banco de España calculations.

a The breakdown is obtained from a structural vector autoregression model with sign and exclusion restrictions on impact, based on Leiva-León, Martínez-Martín and Ortega (2022). The estimation sample covers the period 2002-2023.
b Global supply and demand, profits and the labour market.
c The lines represent the difference between the deviation of the series from its historical average in Spain and that in the euro area. This difference is very similar to that between the gross series, but it makes it possible to better capture the different behaviour of the two regions.

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— Supply shocks have also contributed to the greater buoyancy of activity in Spain, explaining around one-third of the difference in growth between Spain and the euro area as a whole in 2023 (see Chart 1.9.a).

— This is also consistent with a series of recent supply-side developments. In 2023 energy prices slowed down earlier and more sharply in Spain. Indeed, the pass-through of global energy commodity prices to national price indices and, therefore, inflation, has been very different in Spain and the euro area in recent times. For example, at end-2023 the prices of the gas and electricity components of the harmonised index of consumer prices (HICP) in Spain stood below their 2021 levels, while in the euro area they were still 40% to 50% higher. This was mainly due to two reasons. First, the Spanish economy was less exposed to the risk of Russian gas supplies being cut-off, as it had more diversified supply sources.

This reduced uncertainty and the need for industry to find alternative sources of energy.[31] Second, the sharp increase in electricity generated from renewable sources in Spain (from 42% in 2022 to 50% in 2023) drove down wholesale electricity prices more than in the euro area. Moreover, these reductions were passed through to retail prices more quickly in Spain, given its idiosyncratic price-setting mechanisms.[32]

— The differences in the sectoral composition and position in global value chains of the Spanish economy and of other European economies also partly explain the greater boost to activity in Spain from supply-side factors. In particular, the Spanish economy benefited from the fact that services – which grew faster than the industrial sectors, especially those most dependent on energy as an intermediate input – account for a larger share of its productive system.[33]

Job creation in Spain remained highly buoyant throughout 2023, amid some labour market tightening.

— Employment grew strongly in 2023. Over the course of the year, employment increased by 1.9% in terms of hours worked (3.2% in terms of persons employed). However, it slowed down in the second half of 2023 (see Chart 1.10.a).

— The high annual rates of employment growth, measured in terms of persons employed, exceeded GDP growth rates, leading to declines in apparent labour productivity, which has been falling in year-on-year terms since 2022 Q4 (see Chart 1.10.b).

— Despite robust employment growth, the unemployment rate only declined by 1.1 pp, to 11.8% in 2023 Q4. This reflected the strength of the labour force, which grew by 2.5%, driven by the sharp increase in foreign nationals and the working-age population (1.7%).

— Moreover, the temporary employment ratio tended to stabilise in 2023, following the strong decline a year earlier. Nevertheless, the aggregate temporary employment ratio stood at 17.1% on average in 2023, down 8 pp on the 2021 average, although with large differences between the public sector (30.4%) and the private sector (13.8%). However, this lower share of temporary work than in the period before the 2021 labour market reform coexists with high indicators of labour turnover.[34]

— Again, the sharp increase in employment came hand in hand with a reduction in average weekly working hours, which have not yet returned to pre-pandemic levels. This decline reflects the impact of both temporary factors (the greater incidence of leave due to sickness

31 Balteanu and Viani (2023) and Quintana (2022).

32 In particular, under the dynamic pricing system of the regulated rate for small consumers in force in Spain in 2023, wholesale electricity prices are passed on immediately to the consumer, unlike in most European countries. However, the reform of this rate to take into account electricity prices on the futures market, which will enter into force in early 2024, will bring the speed of the pass-through in Spain closer to that in the euro area.

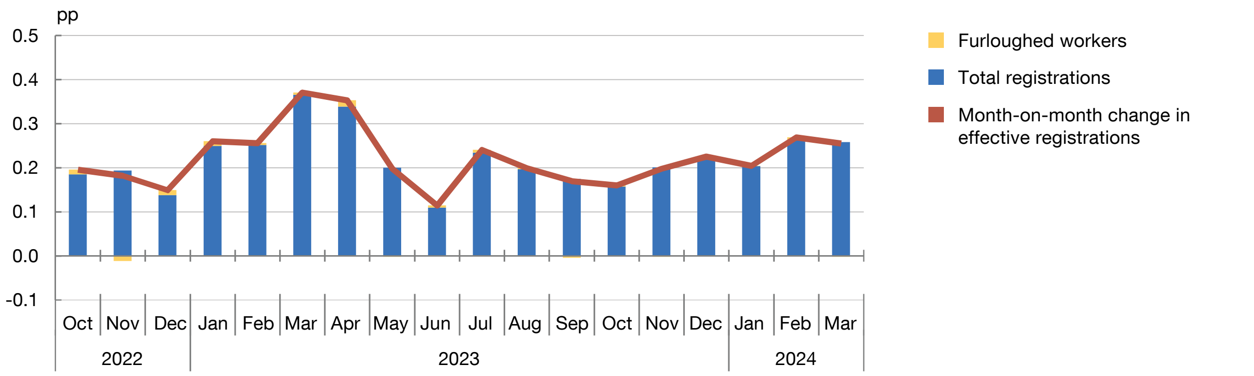
33 For more details, see Fernández Cerezo, Kataryniuk and Rodríguez (2023).

34 See Chapter 3 of this report.

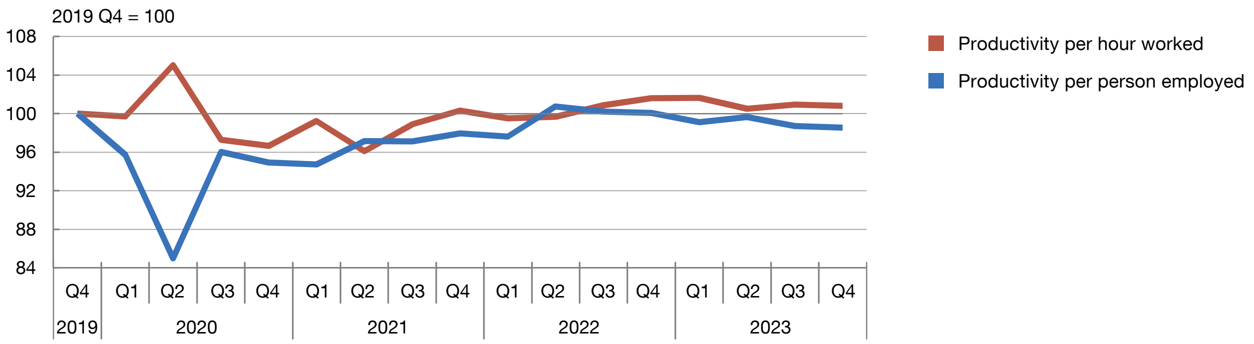
Chart 1.10

Employment grew strongly in 2023, exceeding its pre-pandemic level. However, this strength translated into a decline in apparent labour productivity

1.10.a Monthly change in effective social security registrations (a)



1.10.b Changes in productivity per hour and per person employed since 2019



SOURCES: INE and Ministerio de Inclusión, Seguridad Social y Migraciones.

a Seasonally adjusted monthly rates.

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or incapacity for work, in part associated with the consequences of COVID-19) and trend factors (the increase in female participation, the share of the services sector in the economy and part-time work).[35]

— Against this background, the labour market showed some signs of tightening, with increases in the vacancy rate and in the incidence of labour shortages at firms. This tightness in the labour market could be at least partly explained by a certain degree of labour hoarding by firms[36] (see Chapter 3 of this report for more details on these aspects).

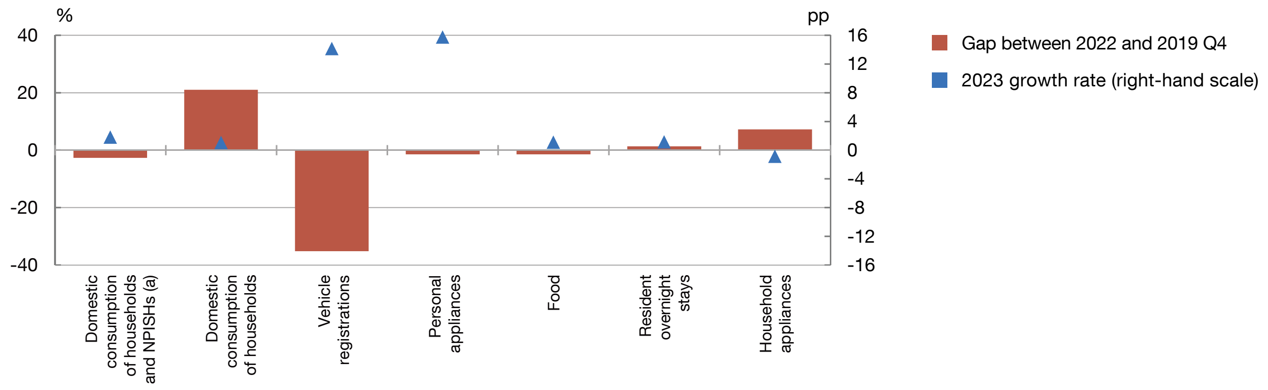
GDP growth over the course of 2023 was mainly underpinned by buoyant household consumption expenditure, while investment growth was rather weak.

35 Cuadrado (2023).

36 This concept refers to keeping workers on the payroll during slack periods in anticipation of future labour demand needs. The reduced willingness to lay off workers is due to greater recruitment difficulties and the uncertainty built up during the pandemic and the subsequent period of supply shocks.

Chart 1.11
Consumption was the main driver of growth in 2023, with notable increases in the expenditure items that were furthest from their pre-pandemic levels at the start of the year

1.11.a Household spending (annual average, growth in 2023 and difference between the level at end-2022 and that in 2019 Q4)



SOURCES: INE and Eurostat.

a Non-profit institutions serving households.

— Household consumption was one of the main drivers of growth in 2023. Growth in this aggregate (1.8% in annual average terms) meant that it had returned to pre-pandemic levels by the end of the year. Vehicle registrations, which at end-2022 were 35% below their pre-pandemic level, were highly dynamic in 2023, growing by 14% (see Chart 1.11). From a longer time perspective, it can be seen that, since the start of the pandemic, the share of spending on durable goods – for example, on items related to household appliances – has increased at the expense of the other items.

— In addition to some demand pent up from the pandemic (for example in the case of motor vehicles), the factors that contributed to consumption growth include the strength of the labour market and the buoyancy of labour income and inflows of immigrants. Specifically, robust job creation and higher wages, together with the moderating path of inflation, appear to have boosted households’ purchasing power somewhat. These developments helped to cushion the negative impact of tighter financing conditions on consumption, in a context in which the stock of consumer credit nevertheless saw some growth.

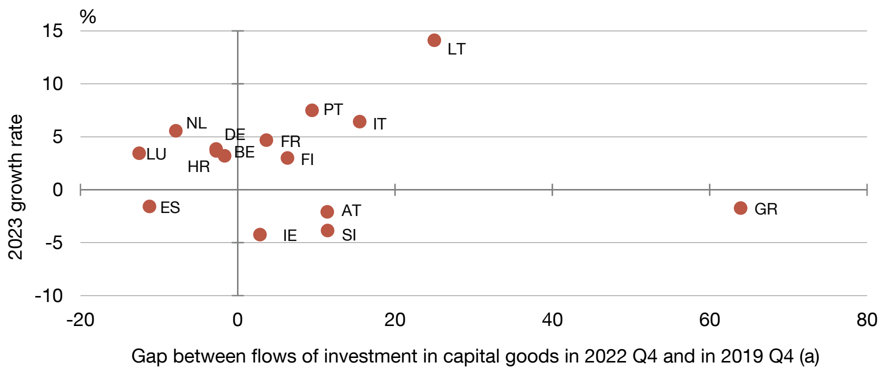
— Indeed, despite this tightening, and according to the information from the ECB's Consumer Expectations Survey, Spanish households – in particular those with a lower liquidity buffer – appear to have resorted to consumer credit to a greater extent – more than in the euro area – and increased their working hours to maintain their consumption levels.[37]

37 Martínez Carrascal (2024).

Chart 1.12

Spain is the only euro area economy where investment in capital goods fell despite having a negative gap relative to 2019 levels

1.12.a Investment in capital goods



SOURCES: INE and Eurostat.

a Except Belgium, where no quarterly series are available for this aggregate and for which the gap between investment levels for the whole of 2022 and 2019 is shown instead.

— This notable increase in household income allowed households in 2023 to combine higher consumption with an increase in their saving rate to levels above its historical average. In addition, households appear to have allocated part of these savings to the early repayment of loans, as rising interest rates provided an incentive to repay variable-rate mortgages.

— Investment in capital goods declined moderately in 2023, while investment in intangible assets was somewhat sluggish.[38] Thus, when the gap in investment rates between 2019 and 2022 is set against investment in 2023, Spain is the only euro area economy where investment fell despite having a negative gap compared with pre-pandemic levels (see Chart 1.12).

— Notable among the factors that have weighed on the dynamism of investment in Spain are the high levels of economic policy uncertainty – according to the Banco de España Business Activity Survey (EBAE) –,[39] the impact of higher interest rates on loans to firms, which intensified over the course of the year more than in the case of consumer credit, and the later than initially planned implementation of NGEU projects compared to what was initially planned (see Box 1.1 for more details).

— Residential investment increased slightly in 2023 compared with 2022, in a context where higher interest rates seem to be having a stronger impact on the mortgage market than on housing demand, which has grown on the back of high immigration flows. In fact, house

38 For a more detailed analysis of investment in capital goods and intangible assets since the start of the pandemic, see Chapter 2 of this report.

39 Fernández Cerezo and Izquierdo (2023).

purchases by foreign citizens as a share of total house purchases reached 19% in 2023, close to the peak of the time series. However, the tightening of credit standards appears to have contributed, at least in part, to a decline in home ownership affordability, especially for young people (see Chapter 4 of this report).

Economic activity was bolstered by net external demand, in a context of remarkably strong Spanish exports, especially travel services, and some weakness in imports, which significantly widened the current account surplus.

— Of note on the exports side was the strength of travel services, in a setting where foreign tourist arrivals in 2023 as a whole were 1.9% above their pre-pandemic levels, reaching an all-time high of over 85 million. In addition, the contribution of travel services exports to output growth benefited from the arrival of foreign visitors with higher purchasing power, as evidenced by their average daily expenditure in real terms, up 2.2% on its 2019 level. The factors behind the strong buoyancy of international tourism in 2023, once it had returned to pre-pandemic levels, included a possible positive impact on tourist arrivals of the geopolitical conflicts in the Middle East[40] and, above all, a more diverse range of destinations across Spanish regions and the greater influx of foreign tourists in the autumn and winter season (see Chart 1.13).[41]

— Meanwhile, exports of goods fell in 2023, against the backdrop of a slowdown in the euro area economies, the main destinations for Spanish exports. However, exports to countries such as Germany remained solid, despite the country's sluggish economic growth and in marked contrast to the weakness of exports to Germany in countries such as France and Italy (see Chart 1.14.a). The relatively favourable performance of the Spanish economy's competitiveness indicators in 2023 compared with the euro area as a whole could at least partly explain this momentum. Specifically, the indicator based on consumer prices points to a slight improvement in the competitiveness of the Spanish economy in 2023, while the indicators based on output prices (GDP deflator) and unit labour costs (ULCs) relative to the rest of the euro area suggest it remained practically stable in 2023, albeit with a slight improvement compared with the 2022 average[42] (see Chart 1.14.b).

— On the imports side, the stagnation of goods imports, despite the rise in domestic demand, is a factor behind the positive contribution of net external demand to output growth. Among the determinants of this stagnation are the subdued growth of the demand components with a higher import content (in particular, investment), changes in the composition of the household consumption basket, with own brands (whose production is more concentrated in Spain) accounting for a greater share, the slight improvement in the competitiveness

40 In the past, conflicts in Mediterranean countries have led to higher increases in tourism flows than estimated using the traditional determinants of these flows. For more details on the factors behind the recent upturn in tourism in Spain, see Hernández de Cos (2023).

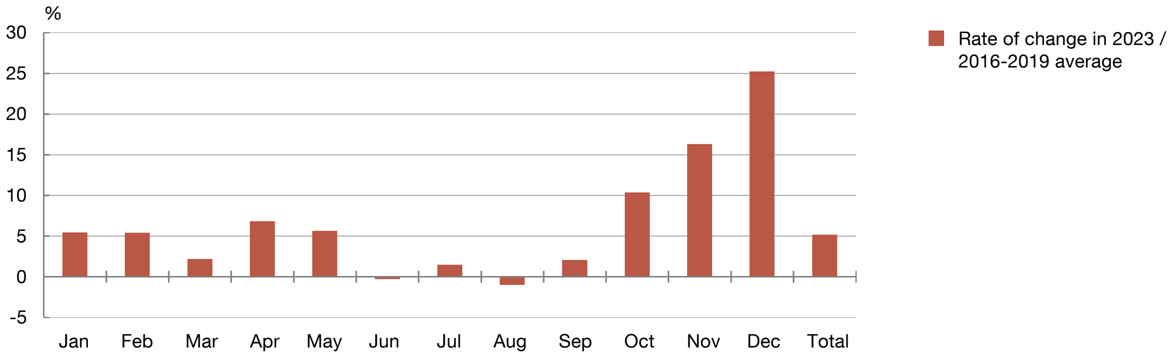
41 For example, arrivals between October and December were 17% higher in 2023 than in the period 2016-2019, while arrivals in the summer months were only 1% higher. For more details, see García Esteban and Jiménez-García (2024).

42 In any event, it should be noted that by end-2023 the ULC-based indicator had not yet recovered from the competitiveness losses recorded during the pandemic.

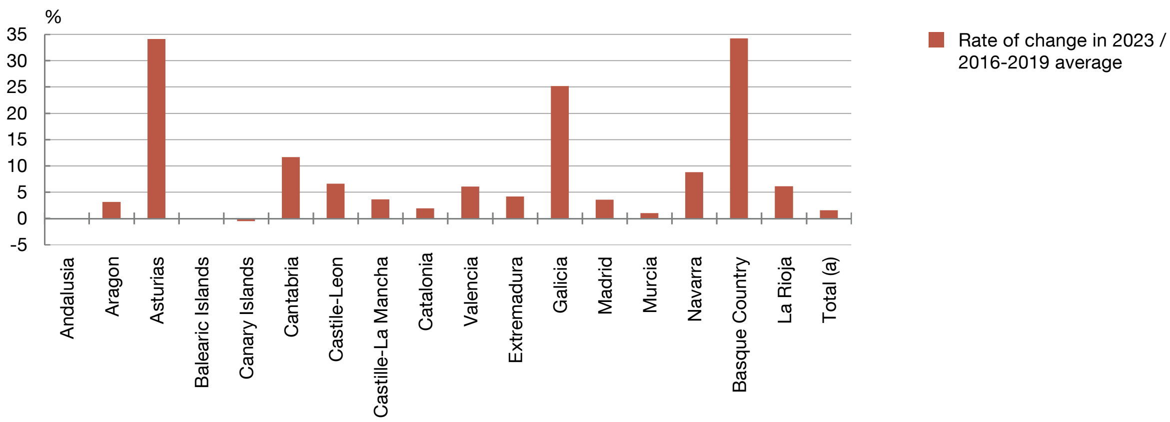
Chart 1.13

Tourism in Spain is becoming more diversified in terms of both seasons and regions, compared with the pre-pandemic period

1.13.a Foreign tourist arrivals, by month. Rates of change in 2023 relative to the 2016-2019 average



1.13.b Overnight stays in hotels by foreign tourists, by region. Rates of change in 2023 relative to the 2016-2019 average



SOURCE: INE.

a Although Ceuta and Melilla are included in the total, they are not included in the breakdown due to their low relative weight in total overnight stays.

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indicators of the Spanish economy and greater domestic energy production, in a context in which Spain has comparative advantages to become a supplier to the European countries most dependent on Russian oil and gas.[43]

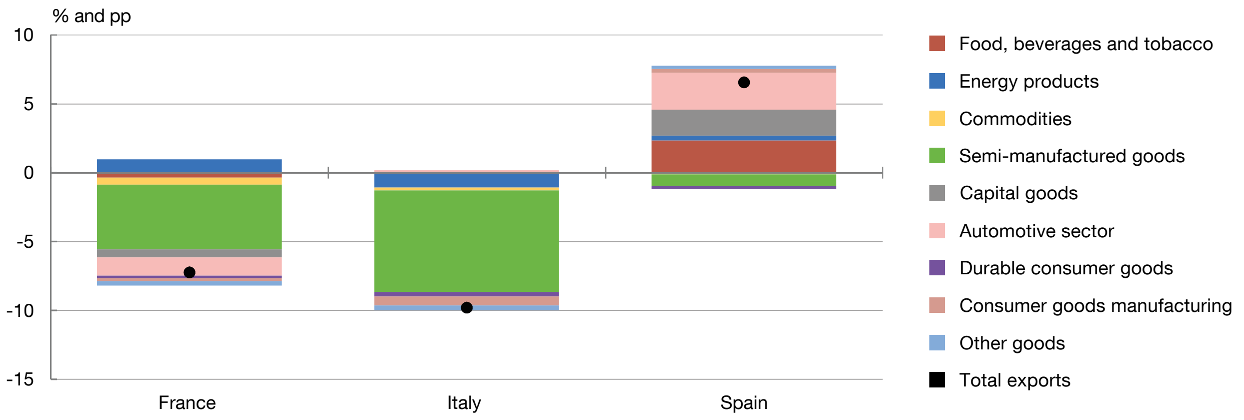
— The external balance for goods and services improved markedly, increasing by 3 pp of GDP, to 4.1% at the end-2023. Thus, in 2023 the Spanish economy's current account surplus increased significantly to around pre-pandemic levels (2.6% of GDP), despite higher interest rates and the sharp widening of the energy deficit, which were more than offset by the increase in the non-energy goods and services balance.

43 García Esteban, Gómez-Loscos and Martín-Machuca (2023).

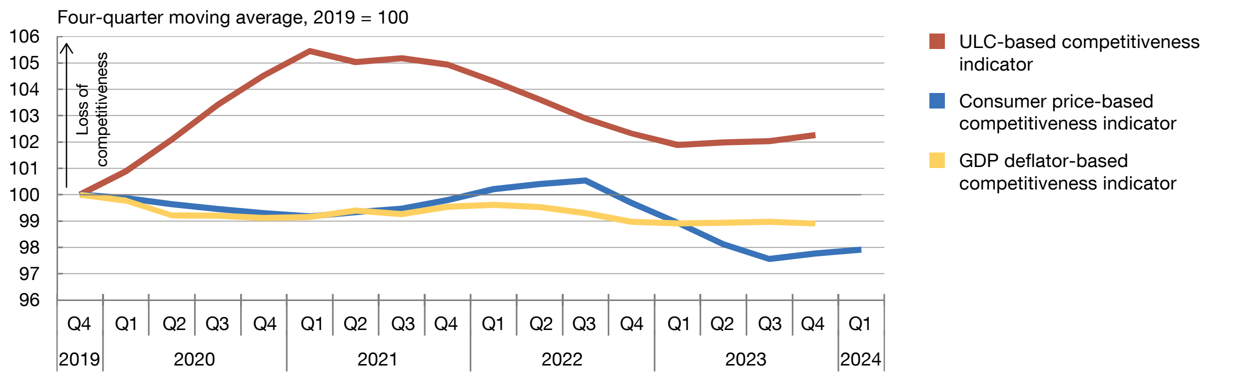
Chart 1.14

Spanish goods exports to Germany grew notably in 2023, amid a slight improvement in Spain's competitiveness indicators compared with the euro area

1.14.a Contribution of each product to the nominal change in exports to Germany between 2022 and 2023



1.14.b Indicators of Spain's competitiveness versus the rest of the euro area (a)



SOURCES: Ministerio de Economía, Comercio y Empresa, Eurostat, ECB and OECD.

a Three harmonised indicators are shown: one calculated using ULCs, another calculated using consumer prices and another calculated using GDP deflators. An increase (decrease) in the indicators implies a competitiveness loss (gain).

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— The current account surplus reflects both the positive external balance of goods and services and the positive difference between aggregate saving and investment in Spain. In other words, the rise in the external surplus in 2023 would also stem from the increase in the household saving rate and in firms' profits, in a context of significantly weak investment.

— The sustained current account surpluses of recent years have led to a substantial correction of Spain's negative net international investment position (IIP), amid private sector deleveraging. In particular, the negative net IIP with the rest of the world has fallen by around 45 pp of GDP from its 2009 peak, to 52.8% in 2023 Q4. However, this negative net IIP remains high compared with the euro area, with the public sector accounting for most of it. Indeed, the general government's negative net IIP with the rest of the world in 2023 (39.5%) was higher than in 2009 (by 13.8 pp of GDP).

Government consumption and social benefits further underpinned activity in 2023, 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.

— Real government consumption surprised markedly on the upside in 2023, with growth of 3.8%, up from -0.2% in 2022. Government consumption would thus be 1.1 pp of GDP above its 2019 level, meaning that a significant part of the increase in government consumption that occurred in the context of the pandemic has become entrenched.

— Expenditure on pensions, driven by the CPI-indexed revaluation of pensions in 2022 and further increases in minimum and non-contributory pensions, also pushed up the growth rate of government spending. In particular, pensions rose by 10.7% in 2023, compared with 5.1% a year earlier. Meanwhile, the expenditure financed by the NGEU programme is estimated to have risen significantly in 2023, compared with 2021 and 2022, albeit less than expected at the beginning of the year.[44]

— As inflation slowed throughout the year, some of measures taken in response to inflation were allowed to expire in 2023, while others were extended to all of 2024 (see Table 1.1). The withdrawal of some measures with a high cost and a particularly broad scope – such as the blanket discount on fuel prices –[45] helped to improve the efficiency of their overall design in 2023, although untargeted measures with potentially distorting effects on prices remain predominant. The budgetary cost of these measures fell in 2023 – and consequently so too did their impact on activity – but remained high (1.2% of GDP compared to 1.5% in 2022).

— Overall, government revenue saw a notable increase of 9% year-on-year in 2023, up 0.5 pp on 2022. However, this dynamism is partly due to the increase in interest received and investment grants from the EU. Indeed, total revenue from taxes and social security contributions grew by 7.9%, 1.6 pp less than a year earlier and 1.1 pp less than total revenue. This occurred in a context where the growth in the macroeconomic bases of the main taxes, the favourable impact on personal income tax collection of fiscal drag[46] and the almost neutral net effect of the revenue measures were expected to result in an increase similar to that of the previous year. Therefore, the slowdown in tax and social security contribution revenues compared with 2022 is mainly due to a change in the sign of tax residuals – the difference between observed revenue and that expected based on the macroeconomic bases and the measures implemented – from positive in the previous years to negative in 2023. This would suggest that the high revenue growth seen during the pandemic (above

44 Total expenditure adjusted for temporary measures and unemployment is estimated to have increased by 8.5% year-on-year in 2023, compared with 9.9% in the previous year. However, considering the decrease in temporary measures and unemployment developments, unadjusted total expenditure would have increased by 6.4%.

45 García-Miralles (2023).

46 Balladares and García-Miralles (2024).

Table 1.1

The authorities have presented a broad raft of measures aimed at countering the effects of the rise in the prices of various goods and services on the incomes of households and firms. The total estimated budgetary cost of these measures is €48.3-€57.1 billion over the period 2021-2025 (3.5-4.1% of GDP)

Support measures for households and firms in response to the energy crisis and inflation (a)

	Applied from	Expected expiry date	Targeted	Budgetary cost in period 2021-2025 (€m)
(1) Income measures				[-29,550,-25,850]
VAT: temporary reduction in rate on electricity	01.07.2021	31.12.2024	No	[-7,000, -6,000]
Excise duty: temporary reduction in rate on electricity	01.09.2021	30.06.2024	No	[-5,000, -4,000]
VAT: temporary reduction in rate on gas	01.10.2022	31.03.2024	No	[-650, -550]
VAT: temporary reduction in rate on food	01.01.2023	30.06.2024	No	[-3,400, -2,900]
Personal income tax: earned income deduction, reductions for self-employed and regional reductions (b)	01.01.2023	Permanent	Partially	[-13,500, -12,400]
(2) Spending measures				[22,450, 27,550]
Fuel rebate for households and professional drivers (c)	01.04.2022	31.12.2023	No	[6,500, 7,500]
Grant to firms affected by energy price increase (d)	01.04.2022	31.12.2023	Yes	[3,500, 4,500]
€200 cheque for vulnerable households (both packages)	01.07.2022	31.12.2023	Yes	[400, 500]
15% increase in non-contributory pensions (including minimum income scheme)	01.04.2022	Permanent	Yes	[1,000, 1,600]
Public transport subsidy (e)	01.09.2022	31.12.2024	No	[4,000, 5,000]
Student grant expansion	01.09.2022	31.12.2022	Yes	[350, 450]
Subsidies to the electricity/gas sector to reduce bills (f)	01.09.2023	31.12.2022	No	[6,000, 7,000]
Social rebate on heating	01.10.2022	Permanent	Yes	[700, 1,000]
(2-1) Total funds				[48,300, 57,100]
(3) Other measures with no direct budgetary cost				
Suspension of tax on electricity generation (g)	01.07.2021	31.12.2023		
Iberian exception	01.10.2021	31.12.2022		
Price cap for butane gas	15.06.2022	31.12.2023		
Cap on rental increases	01.04.2022	31.12.2023		

SOURCE: Banco de España, drawing on information from the Spanish Government, IGAE, Agencia Tributaria, the EPF and the EFF.

a The estimated budgetary impact of these measures is subject to a high degree of uncertainty and is regularly revised based on incoming data.
b Includes the announced increase in the tax deduction for employment income, with effect from 2024.
c It is estimated that around 50%-60% of this rebate is received by households. Includes the extension from 01 January 2023 until 31 December 2023 for professional drivers.
d Includes support to firms and sectors affected by the increase in energy prices and by the drought.
e Includes the Interrail subsidy.
f Includes the extraordinary subsidy to the electricity sector (from 1 September 2022), assumption of the shortfall arising from the regulated rate for small natural gas consumers (from 1 October 2022) and measures to make electricity and gas contracts more flexible (from 1 January 2023).
g The temporary suspension of the tax on electricity generation (IVPEE by its Spanish initials) is not considered to have a direct budgetary impact as, by law, the receipts are used to cover the electricity sector's costs.

that corresponding to its macroeconomic bases) was somewhat temporary, in line with the lack of conclusive evidence on its driving factors.[47]

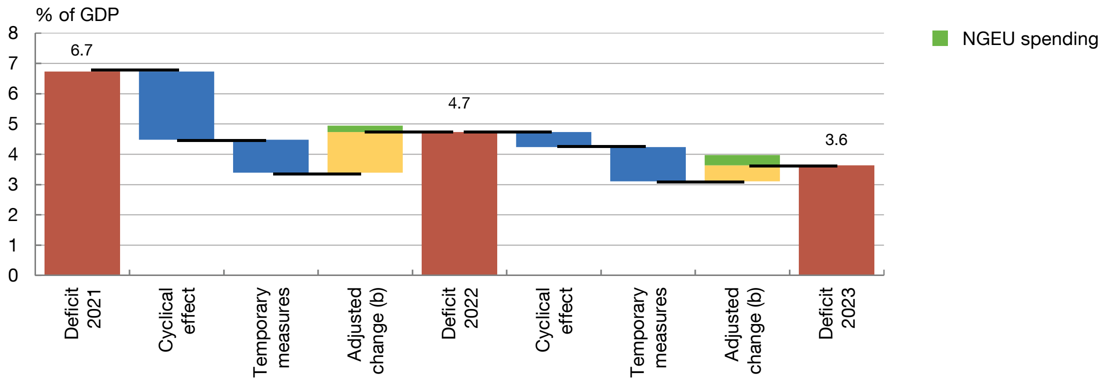
— Overall, 2023 ended with a deficit of 3.6% of GDP, 1.1 pp lower than at end-2022. Thus, the fiscal policy stance – as measured by the change in the cyclically adjusted balance and

47 For more details, see García-Miralles and Martínez-Pagés (2023).

Chart 1.15

The correction of the Spanish general government deficit moderated in 2023, with a much smaller contribution from the economic cycle and a broadly neutral fiscal policy stance (a)

1.15.a General government deficit



SOURCES: IGAE and Banco de España.

a The fiscal policy stance is measured here as the change in the cyclically-adjusted budget balance, which includes the change in temporary measures. Expenditure financed by the NGEU programme is also added. By statistical convention, this expenditure does not have an impact on the national deficit, but it does contribute to the expansionary fiscal policy stance. However, its financing does not, as it is not borne by resident agents.

b Cyclically-adjusted change in the deficit, excluding temporary measures.

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taking into account the stimulus from the NGEU programme – appears to have been slightly contractionary, in contrast to the expansionary stance of 2022 (see Chart 1.15).[48]

On the supply side, the high growth rates in tourism-related services sectors (which accounted for around half of the overall growth in 2023) stand in contrast to the sluggishness recorded in the industrial sectors, thus continuing the shift observed in recent years towards a more services-based economy.

— In the services sectors, real gross value added (GVA) grew notably in the more tourism-related services – such as trade, transportation and hospitality – and in arts and recreation services. Overall, the buoyancy of the tourism and entertainment-related sectors was behind almost 50% of total GVA growth in 2023, despite accounting for less than 30% of GVA.

— Industry and construction recorded GVA growth of 1.8% and 2.3%, respectively, in 2023 as whole, whereas the primary sector saw GVA decline by 1.9%. In manufacturing, the most energy-intensive sectors – which were hit hardest by the rise in energy prices in 2021 and 2022 – have been faring relatively better in Spain than in other euro area countries.[49] For instance, in 2023 the industrial production index for electricity-intensive industries[50] recorded an annual

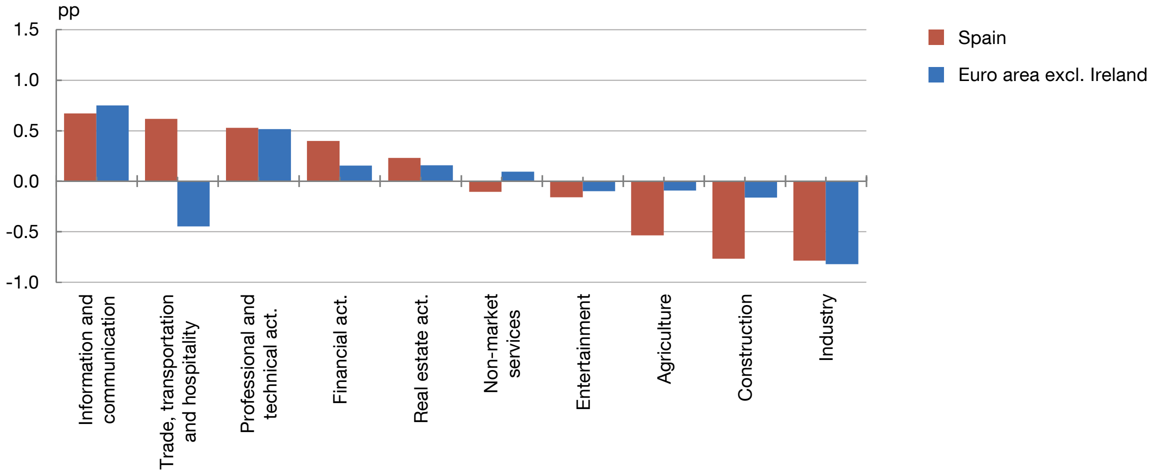
48 The reduction in the size of the temporary measures appears to have contributed to a similar tightening of the fiscal policy stance in both 2022 and 2023. However, in 2022 this was more than offset by growth in cyclically adjusted expenditure and revenue (taking into account the NGEU stimulus and net of temporary measures), while this effect was smaller in 2023.

49 Fernández-Cerezo, Kataryniuk and Rodríguez (2023).

50 According to the definition of the German Federal Statistical Office (Destatis), the electricity-intensive sectors are manufacture of paper and paper products, manufacture of coke and refined petroleum products, chemicals, other non-metallic mineral products and basic metals.

Chart 1.16
The Spanish economy's productive structure has shifted towards services

1.16.a Change in sectors' share in GVA between 2019 and 2023



SOURCES: INE and Eurostat.

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decline of 4.1% in Spain (0.1% for the Spanish manufacturing sector overall), compared with the deeper drop observed in the euro area (-7.6%) and in Germany in particular (-10%).

— From a broader time perspective, compared with the pre-pandemic situation, Spain's productive system has shifted towards services as part of the structural transformation that characterises the economic development process.[51] First, as in the euro area as a whole, the share of information and communication services in GVA increased – driven by accelerated digitalisation in the wake of the pandemic – at the expense of the manufacturing sectors. Second, unlike in the euro area overall, the trade, transportation and hospitality sectors gained considerable share in Spain, while the share of construction and agriculture declined notably (see Chart 1.16).[52]

In Spain, inflation has remained on the slowing path that began in 2022 Q3, mainly due to falling energy prices, while food prices have displayed greater downward stickiness.

— In the first half of 2023, inflation, as measured by the year-on-year rate of change in the HICP, continued the easing trend that began in mid-2022, reaching a low in June. It then

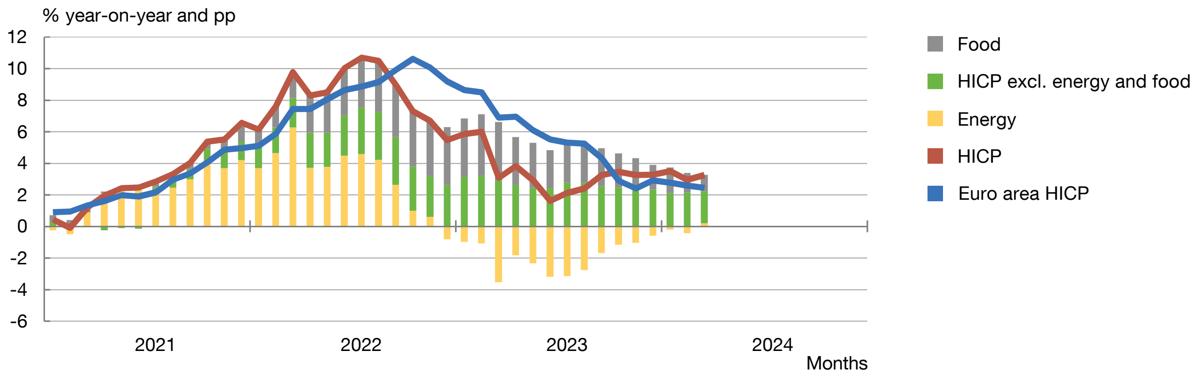
51 González-Díez and Moral-Benito (2019).

52 In particular, the share in total GVA of trade, transportation and hospitality services increased by 0.6 pp in the period 2019-2023, compared with a drop of 0.4 pp in the euro area. In hours worked terms, the drop in Spain (-0.9 pp in 2019-2023) was relatively similar to that in the euro area (-0.6 pp), leading to significant hourly productivity gains in Spain in these sectors (+7%), compared with only a slight gain in the euro area (+0.5%). For a more detailed description of sectoral employment developments since 2019, see Chapter 3 of this report.

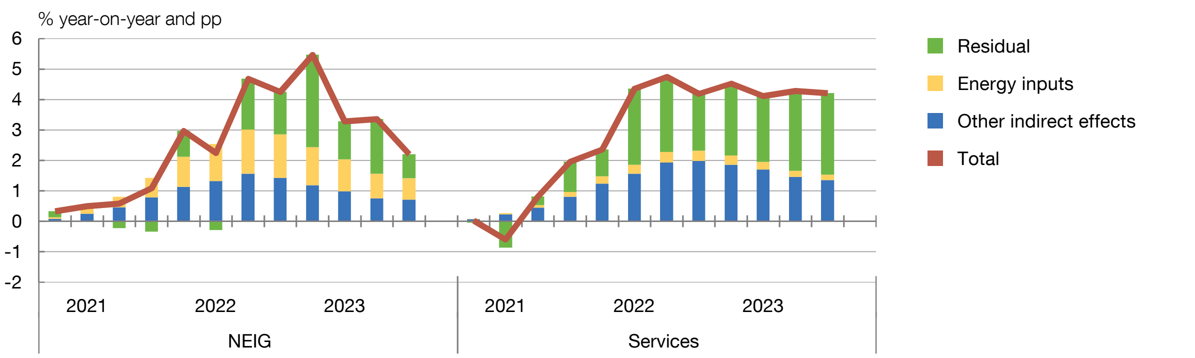
Chart 1.17

In Spain, inflation followed a slowing path throughout 2023, owing primarily to the energy component

1.17.a HICP and contributions



1.17.b Direct and indirect effects of energy on NEIG and services inflation (a)



SOURCES: Eurostat and Banco de España.

a The effects of higher energy prices on the prices of non-energy industrial goods (NEIG) and services are estimated following the ONKIO model proposed in Aguilar, Dominguez-Díaz, Gallegos and Quintana (2024). A shock similar to the energy price shock of 2021-2023 is considered.

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rose slightly and subsequently stabilised at around 3% in the closing months of the year (see Chart 1.17.a). Thus, average annual HICP growth stood at 3.4% in 2023, 4.9 pp down on 2022 and 2 pp less than in the euro area as a whole.

— Inflation developments over the course of 2023 were marked by a slowdown in energy prices. Specifically, consumer energy prices fell by 16.1% on average in 2023, compared with the dramatic increase of 27.6% in 2022. This owed both to lower oil, gas and wholesale electricity prices and to the base effects associated with the steep price rise in 2022.[53]

— Food price developments in Spain also helped to temper headline inflation. Specifically, in February 2023 food inflation reached its highest level since the beginning of the monetary union (15.7% year-on-year). It has since been on a gradually easing path, which is likely attributable to lower pressures on input costs, as reflected in the moderation of domestic producer prices and

53 In addition, at the start of 2023 free market contracts were included in the measurement of gas and electricity prices.

import prices for food and beverages.[54] However, adverse weather conditions for the production of certain food items (such as fruit, vegetables and olive oil) may have contributed to some downward price stickiness in the final stretch of 2023 and the early months of 2024.

— In any event, Spanish headline inflation has been significantly influenced by the government measures approved (or extended) in response to the upturn in inflation. Overall, these measures have helped to contain the prices of certain consumption basket items, although their impact on headline inflation in 2023 was limited due to the reversal of some of the energy price measures[55] (see Table 1.1).

— The 2 pp negative inflation differential between Spain and the euro area overall owed primarily to energy prices slowing more markedly in Spain than in the euro area. This was mainly because wholesale electricity prices passed through to consumer prices more rapidly in Spain than in most European countries, as noted above. However, the price differential has turned positive in recent months, especially in the energy and food components.

Since early 2023 core inflation has followed a gradually slowing path. However, it remains high and shows some cross-component heterogeneity.

— Core inflation, measured as the HICP excluding energy and food, peaked at 5.2% in February 2023. It subsequently embarked on a downward path, ending the year at 3.5%. Thus, average inflation in 2023 stood at 4.1%, 0.3 pp higher than in 2022 and 0.8 pp below the euro area average, although that gap narrowed in the second half of the year.

— Non-energy industrial goods (NEIG) inflation was mainly shaped by the fluctuations in energy input prices. Thus, in line with the energy price moderation that began in late 2022, NEIG inflation slowed relatively sharply over the course of 2023 (see Chart 1.17.b).

— In services, whose production is less energy-intensive and more dependent on labour and other non-energy inputs, inflation appears to have been more influenced by the so-called indirect and second-round effects associated with rising production costs (wage and non-wage alike) in an inflationary setting. Therefore, services prices followed a less steep disinflationary path than NEIG prices (see Chart 1.17.b).[56]

Inflation followed a steeper easing path during 2023 than had been forecast at end-2022, mainly due to the unexpected drop in energy prices, which more than offset the slight upward surprises in food and services inflation.

54 Price developments in the early production stages pass through to consumer food prices with a lag of up to 12 months (Borrallo, Cuadro Sáez and Pérez, 2022).

55 Among those having the largest impact on inflation were the discontinuation of the €0.20 per litre fuel rebate from January 2023, which is estimated to have added 0.4 pp to inflation in 2023. Also notable, albeit in the opposite direction, were the reduction in the VAT rates on certain food items and the transport subsidies, each of which would have reduced inflation by 0.2 pp in 2023.

56 The direct and indirect effects of energy on NEIG and services prices are estimated following Aguilar, Domínguez-Díaz, Gallegos and Quintana (2024).

— The outlook for 2023 headline inflation in Spain, proxied by the average year-on-year rate of change in the HICP, has been consistently revised downwards since late 2022. In particular, the Banco de España's December 2022 projection exercise envisaged an average inflation rate of 4.9% in 2023, while the median analyst forecast stood at 4.5%. However, these projections were revised steadily downwards over the course of the year. As a result, in December 2023 the median analyst forecast was down to 3.6%, while the Banco de España's forecast stood at 3.4%, matching the actual figure (see Chart 1.18.a).

— The main driver behind the downward revisions of inflation forecasts in 2023 was the significantly sharper than expected drop in energy prices. In particular, energy commodity prices – which peaked in the second half of 2022 – declined considerably more rapidly in 2023 (particularly in the winter months) than anticipated by futures markets. This was especially true of natural gas prices. The factors behind these developments notably include high EU natural gas inventories (along with an increase in non-Russian gas supplies), milder winter temperatures than expected (which reduced global energy demand) and record levels of electricity generation from renewable energy sources in Spain[57] (associated with better than expected weather conditions for renewable power generation). All of this resulted in a marked and unexpected drop in Spain's electricity prices, causing the HICP energy component to fall by 16.1% on average in 2023, rather than increasing slightly as anticipated at end-2023 (see Chart 1.18.b).

— In the case of food prices, while some measures not envisaged in the December 2022 projections (such as the reduced VAT rate on some staple food items) helped to contain inflation more than expected at that time,[58] other factors exerted more upward pressure on prices over the course of 2023 than had been anticipated at end-2022. First, higher prices of agricultural commodities and other production inputs appear to have passed through to food producer and import prices more robustly than expected at the close of 2022. Second, adverse weather conditions for the production of some food items in 2023 H2 may have slightly dampened the expected slowdown in consumer prices.

— Core inflation, proxied by the rate of HICP excluding energy and food, was slightly more persistent during 2023 than anticipated at end-2022. In a context in which NEIG prices performed as envisaged at end-2022,[59] the slight upward surprises in core inflation mainly

57 The share of renewable electricity generation reached 50.3% in 2023 as a whole, up from 42% in 2022.

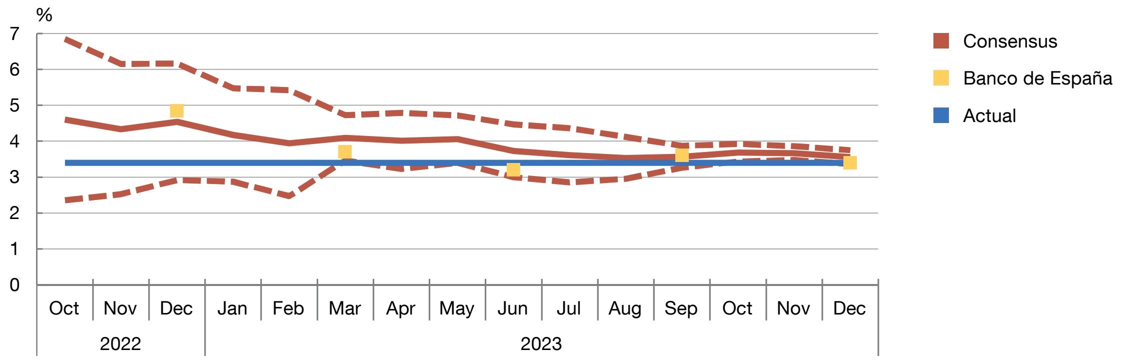
58 Royal Decree-Law 20/2022 of 27 December 2022 reduced the rate of VAT for the following foods from 4% to 0% until 30 June 2023: bread, baking flour, milk, cheese, eggs, fresh fruit, fresh vegetables, legumes, potatoes and cereals. The VAT rate on oil and pasta was reduced from 10% to 5%. This measure was extended by Royal Decree-Law 5/2023 of 28 June 2023 and again by Royal Decree-Law 8/2023 of 27 December 2023. According to the most recent information available, it will end in June 2024. All of these measures contributed to reducing consumer food prices and none of them were envisaged in the Banco de España's December 2022 projection exercise.

59 The absence of any significant NEIG price surprises, amid considerable downward energy price surprises, could point to a smaller pass-through of energy costs to producer and consumer prices than was expected at end-2022. However, quantifying this pass-through is a very complex task, especially in an environment such as the current one, with a confluence of various factors that were not envisaged at end-2022 and that have opposing effects on the price-setting process. In addition to energy price developments, these factors notably include the methodological changes in how the INE calculates the HICP and the price fluctuations of non-energy inputs.

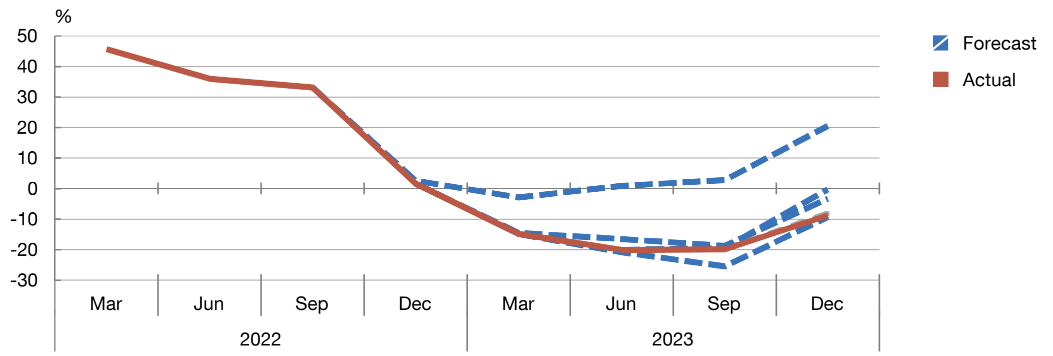
Chart 1.18

Inflation followed a steeper easing path over the course of 2023 than had been forecast at end-2022, mainly due to the unexpected drop in energy prices

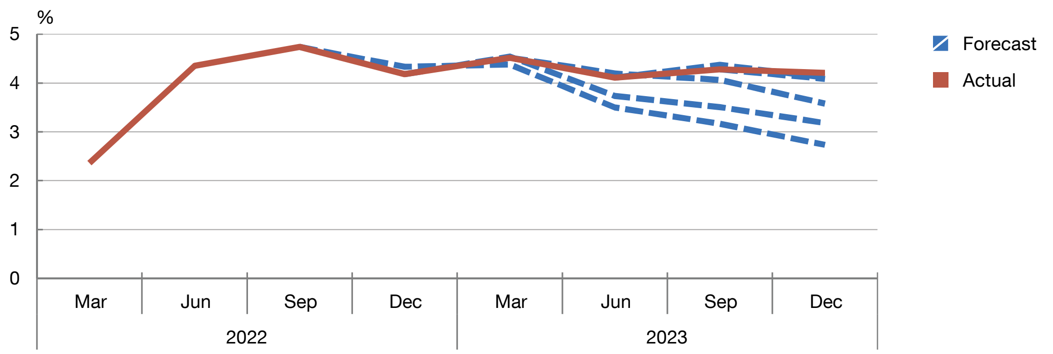
1.18.a Average HICP rate forecast for 2023 (a)



1.18.b Energy HICP: projected paths at the cut-off date of each projection exercise (b)



1.18.c Services HICP: projected paths at the cut-off date of each projection exercise (b)

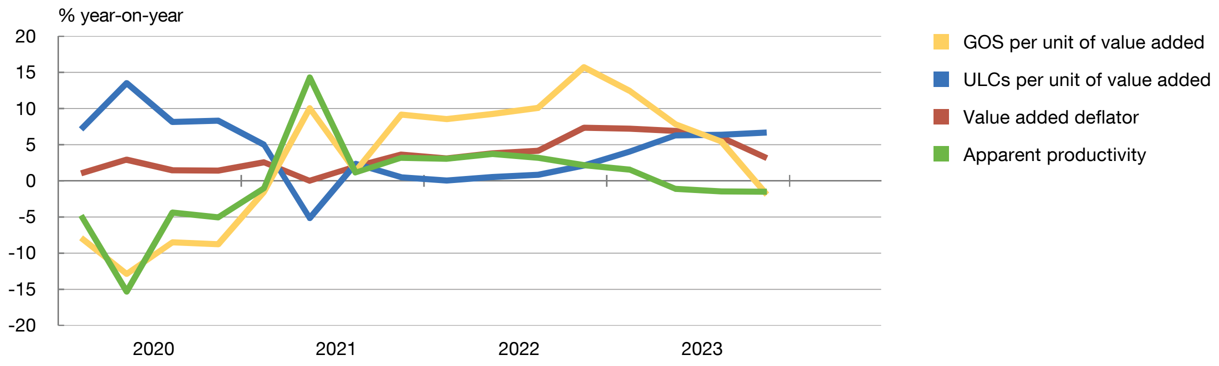


SOURCES: Consensus, INE and Banco de España.

a The dotted lines denote the Consensus panellists' highest and lowest forecast.
b The dotted lines denote the paths forecast in the Banco de España's projection exercises of December 2022, March 2023, June 2023 and December 2023.

Chart 1.19
ULCs were up signifcantly in 2023 against a backdrop of declining productivity, while unit GOS growth slowed sharply

1.19.a Value added deflator. Overall economy



SOURCES: Eurostat and Banco de España.

owed to services showing greater downward stickiness than anticipated (see Chart 1.18.c),[60] probably as a result of two main factors: first, stronger demand for services (especially entertainment, tourism and hospitality services) than initially expected (see Box 1.1), contributing to a less pronounced slowdown in services prices than anticipated; and, second, the relatively high share of labour input in the services sectors, together with compensation per employee proving more buoyant than expected, as discussed below.

Compensation per employee increased significantly in 2023 (more than initially expected and faster than wage settlements), although the corresponding impact on domestic inflationary pressures, measured by the rate of growth in the value added deflator, was cushioned by the slowdown in unit operating surpluses.

— Average annual growth in the value added deflator increased by just over 1 pp (to 5.7%), although it followed a downward path in 2023. This owed to the appreciable moderation in the growth rate of the unit gross operating surplus (GOS), compared with the increase in ULCs (see Chart 1.19).

— Compensation per employee in the market economy grew by 6.3% on average in 2023, up from 4.4% in 2022. Furthermore, this marked increase in 2023 was significantly higher than the 4.1% expected in December 2022 and the negotiated wage increases (3.5% at end-2023), which may be testimony to changes in wage dynamics associated with the labour market

60 It should be noted that this greater stickiness came after the approval (or extension) of public transport measures that were not envisaged in the Banco de España's December 2022 projection exercise, which would have contributed towards downward surprises in services inflation. In particular, Royal Decree-Law 20/2022 of 27 December 2022 provided that multi-trip tickets would be free of charge for regular passengers on public road transport services. It also extended the central government-financed 30% discount on city and intercity public transport (season and multi-trip tickets), albeit contingent on the regional government or local authority financing a further 20% discount. The December 2022 projection exercise did envisage the extension of the 30% discount, but not the additional 20% financed by regional or local authorities.

tightening, especially in certain sectors. Amid weak productivity, this upturn in compensation exerted upward pressure on ULCs, which followed a rising trajectory over 2023.[61]

— Unit GOS developments were reflected in profit margins, measured as the GOS/GVA ratio available in National Accounts, which declined over the course of 2023 in what was a relatively broad-based trend across the sectors.[62] However, the operating margin, proxied as the ratio of gross operating profit (GOP) to turnover, showed a robust recovery profile during the year, which, coupled with the rise in firms' turnover, led to higher aggregate profits.[63]

— Once the impact of supply-side shocks on the cost of certain inputs has been absorbed, the labour market tightening and higher ULCs appear to be gaining in importance as determinants of inflation, and could potentially have a more persistent impact in the future.[64]

— In any event, the rise in household employment incomes have likely helped to limit the impact that the cumulative interest rate increases have had on household vulnerability. Meanwhile, favourable corporate earnings appear to have tempered the rise during 2023 in the percentage of firms that may be deemed vulnerable based on the financial pressure they are under (see Box 1.2).

Looking ahead to the coming quarters, amid a relatively benign global economic and financial outlook, expectations point to the Spanish economy remaining notably buoyant and inflation continuing on its moderating path.[65]

— Broadly speaking, the global economic and financial outlook is relatively positive. In particular, the forecasts for global growth envisage some stabilisation (albeit at modest rates by historical standards and with geographical heterogeneity), while global inflation is expected to remain on a moderating path. In line with these forecasts, international financial markets are discounting policy rate cuts by the main advanced economies' central banks over the course of 2024, which will result in more accommodative financial conditions.

— In the case of the Spanish economy, economic activity has been slightly more subdued in early 2024 than in late 2023, although a mild acceleration is expected over the course of the year, in line with the moderating path of inflation (and the attendant recovery in agents' real incomes), the gradual recovery expected in the European economy and the impetus provided by the roll-out of NGEU-funded projects.

61 See Chapter 3 of this report for an analysis of the potential causes of divergence between real wages and labour productivity.

62 This was consistent with information from the sample of firms in the Banco de España's Central Balance Sheet Data Office Quarterly Survey. See *Observatorio de Márgenes 2023 T3.*

63 Profit margins as a percentage of turnover can be used to analyse the pass-through of production costs to selling prices, while profit margins as a percentage of GVA provide insight into the allocation of profits between capital and labour. Thus, the reduction in energy and other commodity costs in 2023 contributed to the recovery in margins on sales, while higher wages resulted in a lower margin on GVA. For more details, see Banco de España (2024c).

64 Ghomi, Hurtado and Montero (2024).

65 For more details, see Banco de España (2024d).

— After picking up slightly in January 2024,[66] headline inflation has since held at levels similar to those observed at end-2023. Underlying inflation, meanwhile, appears to have continued its downward trajectory, while food prices have shown some downward stickiness. In the coming months inflation is expected to return to a downward path, reflecting a gradual moderation in food and underlying inflation, which will more than offset the contribution of the energy component, which is expected to stabilise.

— In any event, the uncertainty surrounding this economic outlook is very high. The main source of risk is turbulence linked to the armed conflicts in the Gaza Strip and Ukraine. In particular, it is impossible to rule out more adverse scenarios in which these tensions persist or even escalate, giving rise to more severe supply shocks that exert upward pressure on inflation and downward pressure on activity. Another significant source of uncertainty is the potential for monetary policy tightening to ultimately have a larger impact on activity and prices than expected.[67]

One particularly important source of uncertainty for Spain's economic outlook is the vulnerability associated with fiscal sustainability, especially after the EU fiscal rules came back into force.

— Over the last few years, Spain's fiscal imbalances – in terms of both the structural deficit and public debt – have become particularly acute. The fiscal policy response to the pandemic crisis and the inflationary upsurge associated with Russia's invasion of Ukraine led to a substantial deterioration in Spain's public finances. Now that the worst phases of both episodes have been left behind, the latest government consumption developments suggest that part of the higher government spending associated with them is starting to become entrenched, driving an increase in the structural deficit since 2019 despite notable revenue growth.[68] The recent decline in the public debt-to-GDP ratio (from its peak of 120% in 2020) has been fuelled by nominal output growth – itself driven primarily by the economic reopening in 2021 and the price inflation in 2022 and 2023 –, which more than offset the debt growth caused by the budget deficit and interest payments.[69]

— In this respect, running very high public debt ratios for prolonged periods lessens the room for countercyclical fiscal policy measures to address adverse macroeconomic shocks and generates vulnerability to shifts in market sentiment.[70]

66 This pick-up was primarily driven by the partial withdrawal of some of the tax measures adopted by the Government to mitigate the effects of the surge in inflation. Specifically, on 1 January 2024 the VAT rate on electricity and gas increased from 5% to 10% and the excise duty on electricity from 0.5% to 2.5%.

67 Given the considerable lag between monetary policy actions and their effect on activity and inflation, the worst – in terms of the impact of higher interest rates on the real economy – should be over by the end of 2024. For more details, see Banco de España (2023b).

68 Specifically, the 2023 structural deficit is estimated at 3.7% in 2023, compared with 3.1% in 2019 and 4.2% in 2022.

69 In particular, according to Banco de España estimates, of the 13 pp cumulative improvement in the public debt-to-GDP ratio in the period 2020-2023, growth in the denominator contributed 30 pp, more than offsetting the contributions of the structural primary balance and interest payments, which increased the ratio by 8 pp and 7 pp, respectively, in that period.

70 For more details, see Hernández de Cos, López-Rodríguez and Pérez (2018).

— Moreover, looking ahead, a number of factors will exert significant pressure on general government spending and, therefore, on fiscal sustainability. First, the far-reaching demographic shifts under way in Spain will, in the coming decades, drive a considerable increase in spending not only on pensions, but also on health and long-term care. Second, the new investment needs associated with the digital and green transitions, along with the country’s defence spending commitments, will also significantly lift government spending requirements. Lastly, although monetary policy tightening has, for the time being, had a limited impact on the general government debt burden – thanks to the lengthening of the average life of debt since 2013 and very strong nominal GDP growth in recent years –, this impact could grow considerably over the coming years, as and when maturities are refinanced at higher interest rates and nominal GDP growth stabilises below current rates.[71]

— Against this background, the introduction of the new EU fiscal rules calls for the design and implementation of a medium-term fiscal consolidation plan, with a view to correcting the structural budget deficit and, consequently, reducing public debt. The economic consequences of such an adjustment plan are uncertain, since they will critically depend on its design, but its implementation will foreseeably result in weaker levels of activity in the short term. However, were the plan to come in concert with a more growth-friendly composition of public spending and revenue, along with the reforms needed to enhance productivity dynamics and lift the employment rate, its positive impact on the economy’s potential growth would shore up the sustainability of Spain’s public finances. This would significantly reduce the likelihood of adverse scenarios that would have negative consequences for economic growth and public well-being. For more details on this and other structural challenges that will shape the Spanish economy over the coming years, see Chapter 2 of this report.

71 Specifically, in 2023 the general government debt burden (as a percentage of GDP) had risen by just 0.3 pp compared to its 2021 low of 2.1%. However, based on the market expectations for future interest rates envisaged in the Banco de España’s latest projection exercise, that figure could rise to 2.8% in 2026.

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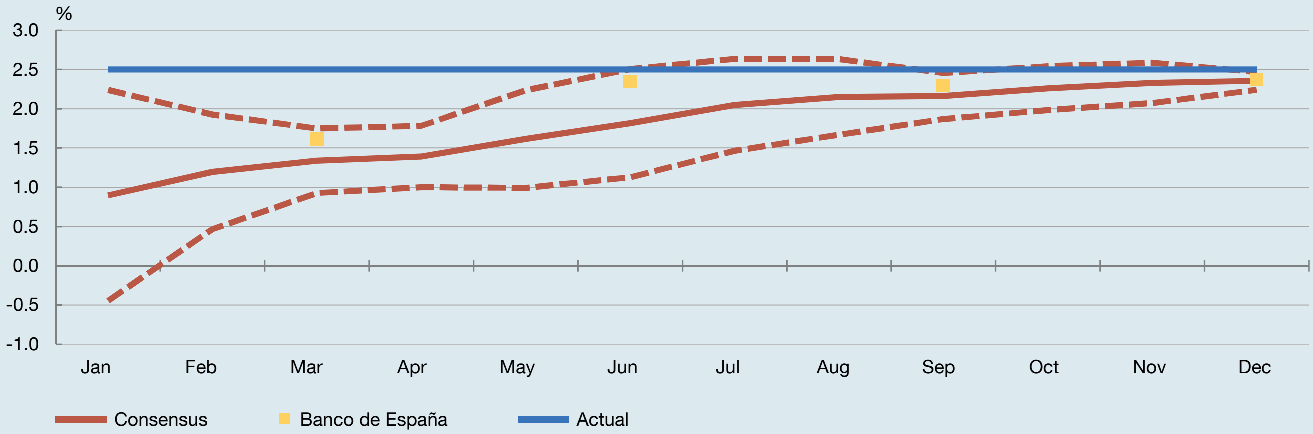
Box 1.1

QUANTIFYING THE DETERMINANTS OF THE SURPRISES IN THE GDP GROWTH FORECAST FOR 2023

In 2023 Spanish GDP grew at an annual average rate of 2.5%, well above the pace of growth projected by the consensus forecast in early 2023 (see Chart 1). This box analyses the various determinants of the 0.9 percentage point (pp) difference between the annual average growth rate projected for 2023 in the Banco de España's March 2023 projection exercise (1.6%)[1] and the growth rate ultimately recorded (2.5%). Specifically, the contributions of the components of domestic and external demand to the surprises in GDP growth in 2023 are quantified, after the effect of statistical revisions has been stripped out,[2] which reduces the size of those surprises from 0.9 pp to 0.5 pp, as described below.

First, mention should be made of the contribution of the new data for 2022 stemming from the revised National Accounts times series released by the National Statistics Institute (INE): some of the differences between the annual average GDP growth rate currently available for 2023 and the rate forecast in March 2023 are due to changes in the 2022 growth rate arising from the new data for 2022 released in 2023. Known as the "carry-over effect", this impact on growth in 2023 depends not only on the revision to average growth in 2022, but also on the quarterly profile of growth that year.[3] In this respect, according to the latest information available, in 2022 GDP grew at an average pace of 5.8%, versus 5.5% on the basis of the information available in March 2023. In addition, the quarter-on-quarter growth rates in the final two quarters of 2022 were also revised up significantly, to 0.5%, from 0.2% on the basis of the information available in March 2023 (see Chart 2.a). As a result of these revisions, even if the quarter-on-quarter growth rates in 2023 had remained unchanged compared with those forecast in March 2023, GDP growth in 2023 would have been 0.4 pp higher, which would explain almost one-half of the total 0.9 pp difference (see Chart 2.b).

Chart 1
Forecasts for 2023 over the year. Rates of change of GDP (a)



SOURCES: Consensus and Banco de España.

a The broken lines denote the Consensus panellists' highest and lowest GDP forecasts.

1 The March 2023 projections are considered instead of the December 2022 exercise because the former is the first exercise in which complete information for end-2022 was available, which allows the role of the new information that became available in 2023 relating exclusively to 2022 to be analysed.

2 Each year the National Statistics Institute releases revised and enhanced National Accounts time series for the three previous years, as additional information becomes available. Thus, revisions to the 2022 time series were published over the course of 2023. For more details, see José Luis Fernández, José González Mínguez, Mario Izquierdo and Alberto Urtasun. (2023). "How do the revised National Accounts affect the interpretation of how the Spanish economy has fared since the pandemic?". *Economic Bulletin - Banco de España,* 2023/Q4, 08.

3 Specifically, higher growth rates in the second half of the year have a larger impact on activity in the following year. For more details, see José González Mínguez and Carmen Martínez Carrascal. (2019). "The relationship between average annual and quarter-on-quarter GDP growth rates: implications for projections and macroeconomic analysis". *Economic Bulletin - Banco de España*, 3/2019, Analytical Articles.

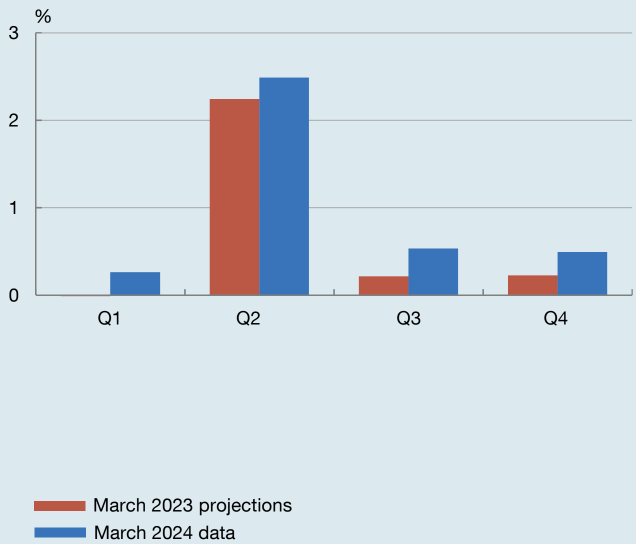
Box 1.1
QUANTIFYING THE DETERMINANTS OF THE SURPRISES IN THE GDP GROWTH FORECAST FOR 2023 (cont'd)

Second, with regard to domestic demand, in 2023 as a whole private consumption grew more than initially expected. Specifically, the average growth rate amounted to 1.8%, 0.6 pp more than projected in March 2023 (see Chart 3.a). Among the various determinants of this surprise, the following should be mentioned. First, the population grew more than expected. Thus, in March 2023 it was expected to grow by 0.5% during the year, but it ultimately grew by 1.1%, mainly as a result of the high momentum of migration flows.[4] Second, consumer credit and other lending performed better than projected, underpinning consumption in a setting in which households, particularly those with low liquidity buffers, borrowed more to cushion the effects of inflation on their spending decisions.[5] Lastly, growth in real disposable income was notably higher than expected (6.5%, versus 1.8% projected in March), as a result of both the high pace of job creation (3.2%, versus the 1.2% initially projected) and the higher than expected increase in compensation per employee (5.4%, versus 4.1%), amid the downside surprises in energy prices (see Section 4 of this chapter). Thus, stronger consumption in 2023 than envisaged in March explains around 0.2 pp of the positive surprise in GDP growth (see Chart 2.b)

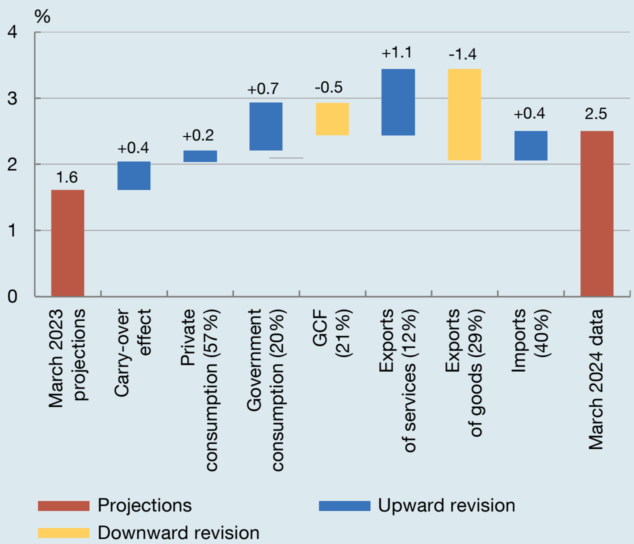
Government consumption also grew more than initially projected, recording average growth of 3.8% in 2023, 3.3 pp more than projected in March 2023 (see Chart 3.a). On data published by the National Audit Office, both intermediate consumption and the compensation of public sector employees grew more than projected (4.0 pp and 1.6 pp, respectively). The indicators available point to public sector employment potentially explaining a large part of the upward surprise in compensation, which in 2023 Q4 stood 10.3% above its pre-pandemic levels according to the Spanish Labour Force Survey. Some of the pandemic-related expenditure in the other components of government consumption has also become somewhat entrenched compared to the March 2023 projections. As a result of these developments, the upward surprises in government consumption explain around 0.7 pp of the surprise in GDP growth in 2023 (see Chart 2.b).

Chart 2
Determinants of the revisions to the GDP growth rate in 2023

2.a Quarterly growth in 2022



2.b Revision compared with the macroeconomic projections



SOURCES: INE and Banco de España.

4 According to Spanish Labour Force Survey data, Spain received around 1.3 million immigrants in 2023 (above the 900,000 expected according to the INE's projections and the average of 500,000 in the period 2016-2019).

5 Carmen Martínez Carrascal. (2024). "Spanish and euro area households' response to rising prices". *Economic Bulletin - Banco de España*, 2024/Q1, 07.

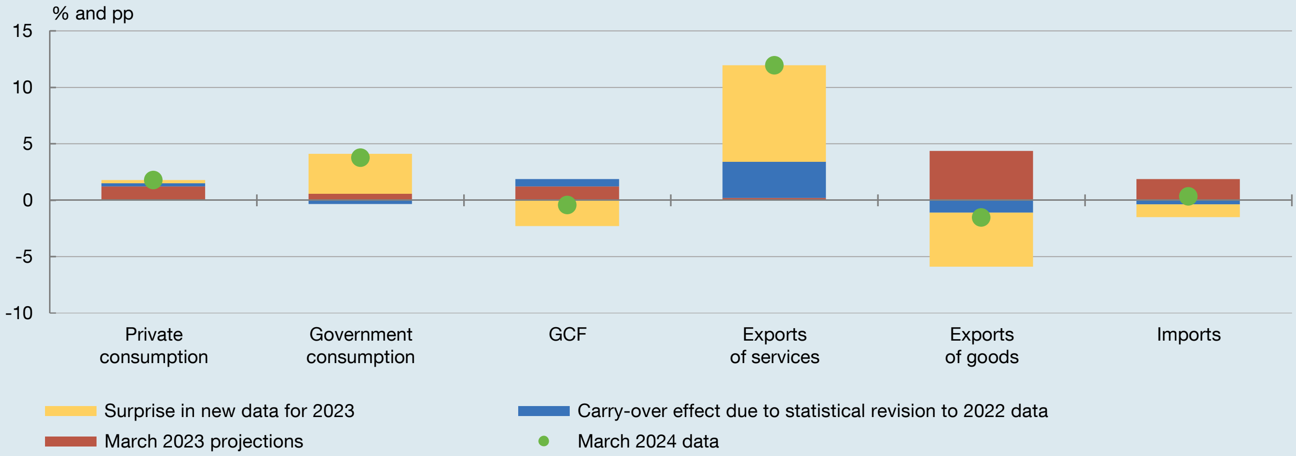
Box 1.1

QUANTIFYING THE DETERMINANTS OF THE SURPRISES IN THE GDP GROWTH FORECAST FOR 2023 (cont'd)

Investment was weaker than expected, with gross capital formation (GCF) falling by 0.4% in 2023 as a whole, versus the growth of 1.2% projected in March 2023 (see Chart 3.a). One of the potential explanations for this is the pace at which Next Generation EU (NGEU) funds were deployed, which was slower than envisaged in March 2023. Specifically, State revenues from investment grants (a proxy of investment expenditure under the Recovery and Resilience Facility (RRF),[6] the centrepiece of NGEU) stood at 0.6% of GDP in 2023, versus the 1.0% projected. Second, mention should be made of the role of labour shortages and the high level of economic policy uncertainty perceived by firms according to the Banco de España Business Activity Survey, which may have resulted in their investment plans being put on hold and/or delayed.[7] Lastly, unlike in the case of consumers, credit standards for lending to non-financial corporations continued to tighten in 2023, especially in the first three quarters.[8] Considering all these factors, the downside surprises in GCF appear to have deducted around 0.5 pp from GDP growth in 2023 compared with the March 2023 projections (see Chart 2.b).

Third, with regard to external demand, exports of services grew more than expected (12.3% in 2023 as a whole, 11.8 pp more than projected in March 2023) (see Chart 3.a). The strong momentum of this demand component was mainly due to exports of travel services,[9] which, having recovered their pre-pandemic levels, were boosted more than expected by several factors. First, the greater diversification of destinations across Spain's regions and the higher number of inbound tourists in the autumn and winter months.[10] Second, the diversion to Spain of flows of tourists who perceive it as a safer destination during times of geopolitical uncertainty in the Middle East (as occurred, for example, during the Arab

Chart 3
Growth rates of the components of GDP and contributions



SOURCES: INE and Banco de España.

6 In the National Accounts, RRF funds are always channelled through the central government, regardless of which general government entity spends them, and they are only recorded when the final expenditure is made. Given that the RRF funds are considerably greater than the investment grants typically received by the central government, State revenue from investment grants can be considered a good indicator of general government capital expenditure charged to RRF funds.

7 Alejandro Fernández Cerezo and Mario Izquierdo. (2023). "Encuesta a las empresas españolas sobre la evolución de su actividad: segundo trimestre de 2023". *Boletín Económico - Banco de España*, 2023/T2, 10.

8 https://www.bde.es/f/webbe/GAP/Secciones/SalaPrensa/NotasInformativas/24/presbe2024-05.pdf (only available in Spanish).

9 Exports of non-travel services also recorded considerable growth, although it was more in line with the March 2023 projections. For more details, see César Martín-Machuca and Coral García. (2023). "Recent developments in Spanish exports of non-travel services". *Economic Bulletin - Banco de España*, 2023/Q3, 05.

10 For more details, see Blanca Jiménez-García and Coral García. (2024). "La reactivación del turismo internacional en España: algunos factores explicativos". *Boletín Económico - Banco de España*. Forthcoming.

Box 1.1

QUANTIFYING THE DETERMINANTS OF THE SURPRISES IN THE GDP GROWTH FORECAST FOR 2023 (cont'd)

Spring).[11] Lastly, long-distance tourism completing its return to pre-pandemic levels also drove exports of travel services in 2023. All told, the strong momentum of exports of services explains around 1 pp of the positive surprise in the GDP growth rate (see Chart 2.b).

Exports of goods fell markedly in 2023 as a whole (-1.6%, versus the strong growth of 4.3% initially projected) (see Chart 3.a). The main factor behind the weak exports of goods was the deceleration in the euro area economies (Spain's main trading partners), which was sharper than expected in early 2023 and, in addition, affected above all the most energy and trade-intensive industries. As a result, the fall in goods exports deducted around 1.4 pp from GDP growth in 2023 compared with the March 2023 projections (see Chart 2.b).

Meanwhile, imports grew less than expected (0.3%, 1.5 pp less than initially projected) (see Chart 3.a) mainly because of the negative surprises in the demand components with the highest import content, i.e. investment and exports of goods. Thus, the sluggishness of imports raised GDP growth by 0.4 pp, largely offsetting the negative contribution from goods exports[12] (see Chart 2.b).

In sum, aside from the positive carry-over effect resulting from the statistical revisions that affected 2022, in 2023 the Spanish economy recorded higher than expected GDP growth mainly because of the upward surprises in exports of travel services and government consumption. Conversely, investment and net exports of goods were weaker than initially projected.

To conclude, it should be noted that these surprises in the demand components arose amid greater disinflation than expected, as discussed in Section 4 of this chapter. Specifically, the lower energy prices on international markets than projected in late 2022 more than offset the slight upward surprises in food and, above all, services inflation, which were at least partly a consequence of the positive surprises in the strength of domestic demand.

11 Banco de España. (2017). "Box 7. Dynamism of non-resident tourism in 2016 and its determinants". *Economic Bulletin - Banco de España*, 1/2017, pp. 23-25.

12 Goods imports account for approximately 85% of total imports.

Box 1.2

THE VULNERABILITY OF HOUSEHOLDS AND FIRMS TO A TIGHTENING OF FINANCING CONDITIONS

The tightening of monetary policy by the European Central Bank (ECB) since the end of 2021 has driven up the cost of financing for households and firms. However, owing to the increase in wages and profits, deleveraging and the rise in the value of their assets, the financial position of households and firms in Spain has actually improved.[1]

Against this background, this box analyses the impact that the gradual increase in the average cost of debt has already had and may have in the future on the financial vulnerability of firms and households. It also assesses to what extent the rise in the incomes of households and firms has mitigated the adverse effect of higher interest rates on their vulnerability. Finally, the potential impact of higher inflation and interest rates is quantified according to the level of household income, given that it is uneven across household types and tends to vary with their level of income.

In the case of households, data from the Spanish Survey of Household Finances 2020 (the latest wave available) are used to calculate the change in the percentage of vulnerable households (those whose income is not sufficient to cover their level of essential expenditure)[2] between 2020 and 2023, under a series of assumptions about how the cost of credit, spending and income changed over that period. First, it is assumed that the cost of variable rate credit increased in line with the change in the annual average level of the 12-month EURIBOR. Second, it is assumed that the price of each component of essential expenditure increased in accordance with the cumulative inflation of its consumption category over the same period. Third, household income is assumed to have increased, uniformly for all households, in line with gross disposable income per capita.[3]

According to the results obtained, the percentage of households that could not cover their essential spending increased by 0.2 pp between end-2020 and end-2023, to 7.2%. However, this increase appears to be somewhat higher for households in the bottom quintile of the income distribution (0.9 pp), with little change for households in the top three quintiles (see Chart 1).[4] Despite the greater increase in the vulnerability of low-income households, among other measures, the support provided to them in the form of transfers, the one-off increase in non-contributory pensions, the increase in the minimum wage, the introduction of the minimum income scheme and the reform of the Code of Good Practice[5] all appear to have contributed to cushioning the adverse effects that higher interest rates and inflation may have had on them. In fact, when the rise in income is ignored, the percentage of vulnerable households increased by 4 pp, with a particularly significant increase in the lowest income quintile (9.4 pp).

As regards the analysis of corporate vulnerability, the firms of interest are those under high financial pressure, defined as those whose interest expenses exceed the sum of their gross operating profit (GOP) and financial revenue. Chart 2 shows the share of total employment accounted for by firms under high financial pressure, according to simulations based on a series of assumptions about the evolution of firms' debt, GOP and cost of debt. Specifically, it is assumed that their GOP will grow uniformly and that all firms' bank and non-bank debt is rolled over as it falls due, while the outstanding balance remains constant.[6] Under these assumptions, and given the observed increase in the average cost of outstanding business debt in 2023 (162 basis points (bp)), the share of

1 Banco de España (2024). *Report on the financial situation of households and firms. Second half of 2023*.

2 Essential spending is defined as the sum of expenditure on food, utilities, rent of main residence and debt payments.

3 The methodology used for this calculation is the same as that used in Box 2 in Banco de España (2023). *Report on the financial situation of households and firms. First half of 2023*.

4 In 2020, expenditure on staple goods (such as food and utilities), rent and debt service already accounted for almost 80% of the income of the lowest income quintile, compared to 44% for the middle quintile. Around 38% of households in the lowest income quintile had some kind of debt in 2020, as compared with more than 59% of households in the middle quintile of the distribution. However, low-income households would have faced higher inflation than other households. Thus, between August 2021 and September 2022, the inflation experienced by the households in the bottom 30% of the income scale appears to have been around 11.3%, as against 9.7% for those in the top 30%. García-Miralles, Esteban. (2023). "Support measures in the face of the energy crisis and the rise in inflation: an analysis of the cost and distributional effects of some of the measures rolled out based on their degree of targeting". *Economic Bulletin - Banco de España*, 2023/Q1, 15.

5 Banco de España. (2023). "Codes of Good Practice for Principal Residence Mortgages and Supplementary Measures". *Financial Stability Report, Spring 2023*.

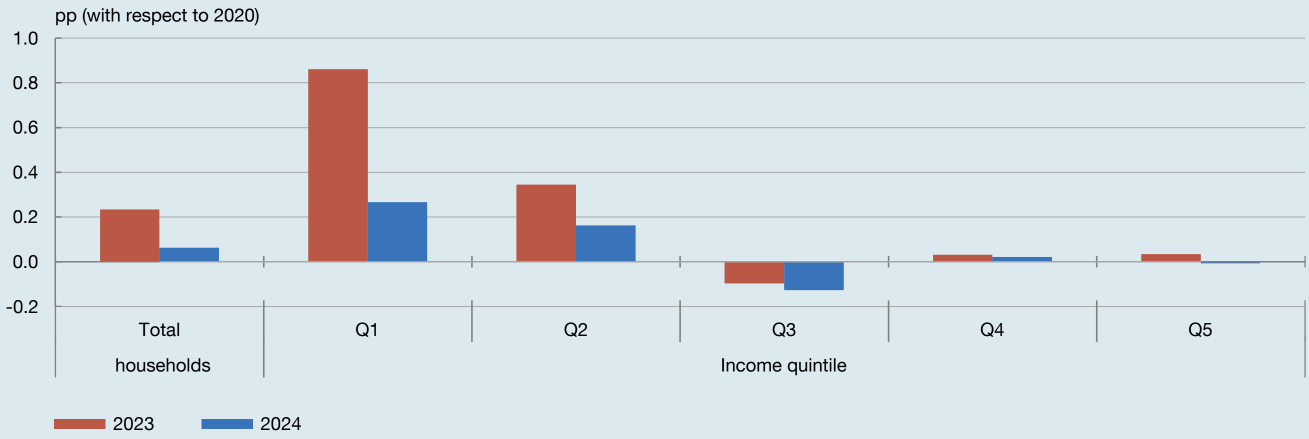
6 For further details of the calculation of the share of employment of firms under high financial pressure in 2023 and 2024, as well as of the simulations carried out for that year, see "Box 2. The impact of interest rate hikes on firms' financial pressure". In Banco de España. (2024). *Report on the financial situation of households and firms. Second half of 2023*. This box also details the assumptions made regarding the outstanding amount of firms' debt, their GOP and the cost of their debt

Box 1.2

THE VULNERABILITY OF HOUSEHOLDS AND FIRMS TO A TIGHTENING OF FINANCING CONDITIONS (cont'd)

Chart 1

Change in the percentage of households whose income does not cover their essential expenditure. Breakdown by income quintile (a)

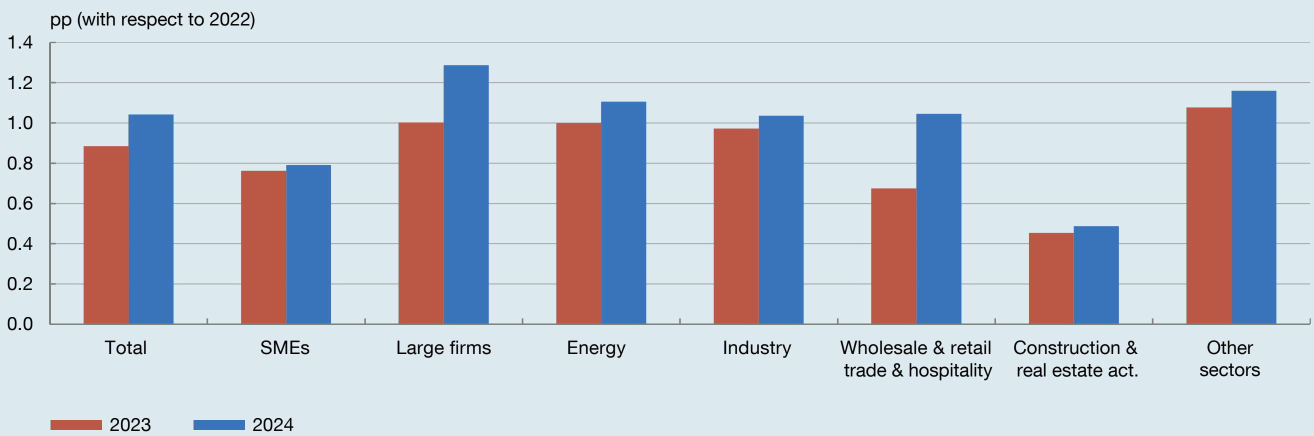


SOURCE: Banco de España (Spanish Survey of Household Finances 2020).

a Essential expenditure is defined as the sum of spending on food, utilities, rent of main residence and debt payments. To approximate the results, the change in interest rates and household income and the cumulative inflation by spending category since 2020 are taken into account. For 2023, an increase in the interest rates on variable rate loans of 417 bp, a 16.3% increase in household income and an increase in essential expenditure in line with the cumulative inflation for its components (food, 26.9%, utilities, 17.8% and rent of main residence, 6.3%) are applied. For 2024, a cumulative increase in interest rates of 344 bp since 2020, an increase in household income of 20.7% and cumulative inflation by spending component in line with the latest Banco de España macroeconomic projections are assumed.

Chart 2

Change in the share of employment of firms under high financial pressure (a)



SOURCE: Banco de España.

a A firm is considered to be under high financial pressure if its interest coverage ratio is less than one. The interest coverage ratio is defined as: (GOP + financial revenue) / financial costs. Calculated on the basis of a sub-sample of firms for which data are available in the Central Credit Register (CCR) or, in the absence thereof, on the basis of firms operating in the same province and sector (at NACE Rev. 2 class level) and of a similar size (based on the European Commission's classification), to which the average cost of financing of the group of comparable firms for which such information is available in the CCR is assigned. The financial costs of each firm for 2023 and 2024 are approximated using the balances of interest-bearing debt at the start of each year and the expected path of interest rates. The following assumptions are made: full debt rollover and an increase in GOP for all firms of 6.4% in 2023, in accordance with the growth observed in the AEAT (with the exception of firms for which CBQ data are available, in which case those data are taken), and of 3.7% in 2024, in line with the growth in the GOP underlying the latest Banco de España macroeconomic projections. Holding companies, head offices and inactive firms are excluded, as are firms with errors in their data on employment, financial cost and interest-bearing debt.

Box 1.2
THE VULNERABILITY OF HOUSEHOLDS AND FIRMS TO A TIGHTENING OF FINANCING CONDITIONS (cont'd)

employment accounted for by vulnerable firms would have increased by 0.9 pp with respect to 2022 (the latest date for which data are available). This increase would bring the share to slightly above its average level in the period 2016-2019. If we consider a scenario in which GOP remains constant, the increase in the share of employment of vulnerable firms would have been 0.2 pp greater.[7] By type of firm, the increase in business vulnerability would have been slightly greater for larger firms and those in the other sectors category, followed by energy and industry, although this deterioration would have been limited in all cases.[8]

Looking ahead, assuming that interest rates move in line with market expectations and that incomes and goods and services prices behave in accordance with the latest macroeconomic projections of the Banco de España,[9] the increase in the percentage of vulnerable agents in 2024 will be limited. Specifically, the increase in the percentage of households that cannot cover their essential spending will be around 0.1 pp (see Chart 1). The increase will be limited even for households in the bottom quintile of the income distribution (0.3 pp). Finally, the share of employment of firms under high financial pressure will not change significantly, although the increases in this share will be non-negligible in some sectors, such as wholesale and retail trade and hospitality (see Chart 2). This is because a small number of relatively large firms belonging to this sector will become vulnerable in 2024.

It should be noted, in any case, that if certain adverse economic growth scenarios materialise the financial position of households and firms could deteriorate more sharply than anticipated. Likewise, in the event that key policy rate cuts are smaller than assumed in this exercise[10] the financial pressure on indebted agents will ease by less than indicated in this box.

7 The reason why a rise in GOP reduces business vulnerability by less than growth in household income alleviates household vulnerability is because more than 90% of firms classified as vulnerable posted a gross operating loss in 2022, and therefore continue to be considered vulnerable in subsequent years.

8 The increase in the share of employment of firms under high financial pressure in these specific sectors is explained by the fact that the rise in interest rates would have caused a small number of relatively large firms to have difficulty covering their interest payments with their ordinary earnings.

9 "Macroeconomic projections for the Spanish economy (2024-2026)". *Economic Bulletin - Banco de España*, 1/2024.

10 In particular, the market expectations of January 2024 regarding interest rate developments are taken into account for the whole of 2024.