EDITORIAL

Editorial

Global economic activity weakened in the final stretch of 2022, although by less than expected. This loss of momentum was essentially a result of the persistence of high inflation and the consequent tightening of monetary policies and global financial conditions. Nonetheless, the falloff in activity was generally less pronounced than had been anticipated by most analysts' forecasts. Among other factors, the easing of bottlenecks in global production chains and the various measures taken by the public authorities to mitigate the effects of the inflationary surge and the energy crisis on the incomes and the consumption and investment decisions of private agents appear to have contributed to this greater resilience.

Moreover, the favourable developments in energy commodity markets (in particular, in the gas market) have helped to check the economic slowdown in recent months, especially in Europe. The rise in the price of gas and the deterioration in the security of supply of this commodity played a very important part in the worsening of the European economic outlook following the outbreak of war in Ukraine. However, in recent months this negative supply shock has been reversed more sharply than expected. In particular, largely as a result of the measures taken to discourage consumption and diversify supply, and of the mild early winter temperatures, gas prices have recently fallen below their pre-war levels and the risks of supply cuts in some of the main European economies have abated considerably.

In the first few months of 2023, there appears to be evidence of incipient improvement in the global economic environment. The signs of resilience exhibited by global economic activity in late 2022, the change in trend of many confidence indicators and the fact that China's abandonment of its zero-COVID policy appears to have had only a relatively transitory negative impact on its economy are some of the factors that have led many analysts to raise their growth forecasts for 2023 Q1 and for the year as a whole.

Also, some signs are discernible of inflationary pressures easing, although they have tended to be confined to the energy price component. In fact, generally, both food and the underlying component continue to display high inflation rates, which, in some cases, are still accelerating.

In comparison with these relatively positive developments, the appearance, following the closing date for this report,[1] of an episode of severe financial tensions at global level has brought about a new adverse shock of uncertain magnitude and persistence. This turbulence arose as a result of the deterioration in the financial position of a particular US bank with a very specific balance sheet structure, which made it particularly vulnerable to rising interest rates. Nonetheless, the fragility of this bank has generated doubts on international capital markets as to

1 The cut-off date for this report is 2 March 2023.

the soundness of other financial institutions. All this has occurred against a background in which interest rates have, in historical terms, been rising very sharply and rapidly across the world in recent quarters. As a result of these doubts, a large majority of the world's banks have recently experienced a significant decline in their stock market valuations and some of them (in the United States and in Switzerland) have required specific support from the authorities. There is currently no way of knowing whether, in the immediate future, these financial tensions will persist or whether they will gradually diminish. In any event, it seems likely that the uncertainty that has been generated will have some adverse impact on economic activity in the coming quarters and will also help to weaken the inflationary dynamics.

In such an uncertain context, at its meeting on 16 March, the European Central Bank's (ECB) Governing Council decided to increase its key policy interest rates by 50 basis points (bp), in line with its determination to ensure the timely return of inflation to the 2% medium-term target. Moreover, the Governing Council stressed how the elevated level of uncertainty (to which the recent global financial tensions have contributed) reinforces the importance of a data-dependent approach to its future monetary policy decisions, based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission, in particular.

The ECB's Governing Council stressed that the euro area banking system is highly resilient, with sound capital and liquidity positions. It also announced that it will closely monitor financial market tensions and that it stands ready to respond as necessary to preserve both price stability and financial stability in the euro area. The ECB's policy toolkit is fully equipped to provide liquidity support to the euro area financial system if needed and to preserve the smooth transmission of monetary policy.

In the first quarter of the year, the Spanish economy appears to have maintained a similar rate of momentum as in the second half of 2022. In 2022 Q4, GDP grew by 0.2%, against a background of notably weaker domestic demand, reflected, in turn, in a decline in imports. In early 2023, the favourable performance of social security registrations and the improvement in confidence indicators, among other factors, suggest that the rate of output growth may have increased slightly, to 0.3%. This would be consistent with the persistence of a certain degree of weakness in the macro-financial dynamics of the Spanish economy, in line with the information from the latest edition of the Banco de España Business Activity Survey (EBAE).[2] In particular, spending by Spanish households and businesses continues to be constrained by two important headwinds: persistently high inflation rates and rising interest rates.

Consumer price inflation has eased significantly in Spain since the highs recorded in the summer, although this has been almost exclusively attributable to the energy component. Indeed, as a result of energy prices moderating in Spain (to a greater degree than for other

2 Mario Izquierdo. (2023). "Encuesta a las empresas españolas sobre la evolución de su actividad: primer trimestre de 2023". *Boletín Económico - Banco de España,* 1/2023, 21. https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/23/T1/Fich/be2301-art21.pdf

European countries owing to the specific features of the Spanish electricity price-setting mechanism), year-on-year rates for this component have recently turned negative. However, the price of food – which makes up a particularly large share of lower-income households' consumption basket – has continued to accelerate, and underlying inflation has only eased very modestly to date. This downward stickiness of inflation in non-energy industrial goods and in services probably reflects the fact that the energy cost increases were passed through to final prices with something of a lag (as is also suggested by the Banco de España's Business Activity Survey), and, perhaps, the existence of asymmetries in the pass-through of these cost increases and the recent decreases.

The macroeconomic projections presented in the final section of this report (completed in early March, before the recent turmoil on the international financial markets) envisage a gradual strengthening in Spanish economic activity over the coming quarters. Contributing to the faster pace of output growth will be, among other factors, the expected reduction in inflationary pressures, a stronger international setting (driven in part by the reopening of the Chinese economy and the easing of global supply chain bottlenecks) and the launch of a growing number of investment projects under the Recovery and Resilience Facility of the Next Generation EU (NGEU) programme. At any rate, in terms of annual average growth, the favourable impact of these dynamics on activity will be especially visible in 2024 and 2025, when GDP will grow by 2.3% and 2.1%, respectively. In 2023, however, Spanish GDP will post growth of 1.6%, significantly below the 5.5% recorded in 2022, on account of the notable slowdown in Spanish economic activity in the second half of last year.

The projections also envisage a gradual easing of the current high inflationary pressures. In annual average terms, headline inflation will fall from 8.3% in 2022 to 3.7% in 2023, mainly on account of the negative base effects in the energy component and the expected decreases in energy commodity prices over the coming months, based on current futures market prices. However, when the main measures deployed by the authorities to mitigate the effects of the energy crisis expire, the acceleration in the energy component will lead to a much more modest decline in headline inflation, to 3.6%, in 2024, before it falls once again to 1.8% in 2025. Meanwhile, underlying inflation is expected to ease more slowly than headline inflation over the projection horizon, and is actually projected to rise from 3.8% in 2022 to 3.9% in 2023, before slowing to 2.2% in 2024 and 1.8% in 2025.

Against a backdrop of very high uncertainty, which has been exacerbated by the recent global financial tensions, the risks to these projections are tilted to the downside in the case of economic activity and appear to be balanced in the case of inflation. The main risk (to the downside in the case of activity and to the upside in that of inflation) continues to be linked to the possible geopolitical developments of the war in Ukraine, should it prompt further supply disruptions similar to those experienced in much of 2022. One risk that was already significant at the projection cut-off date and has since become more prominent is the possibility of further financial market turmoil. This would have downward effects on activity and prices, through two channels: an erosion of economic agents' confidence and a sharper tightening of financial conditions than currently anticipated. However, as mentioned above, a hypothetical swifter pass-through of the recent decreases in energy prices to other consumer prices in Spain and the rest of the euro area would be conducive to lower inflation and a greater rise in domestic demand, by bolstering real incomes and reducing the need for further monetary policy tightening. Conversely, while the risks of the current inflationary episode becoming more persistent have lessened, the possibility of feedback loops between wage and price increases cannot yet be ruled out. Lastly, on the external front, the effects of the reopening of the Chinese economy on global activity and inflation are uncertain.