REPORT

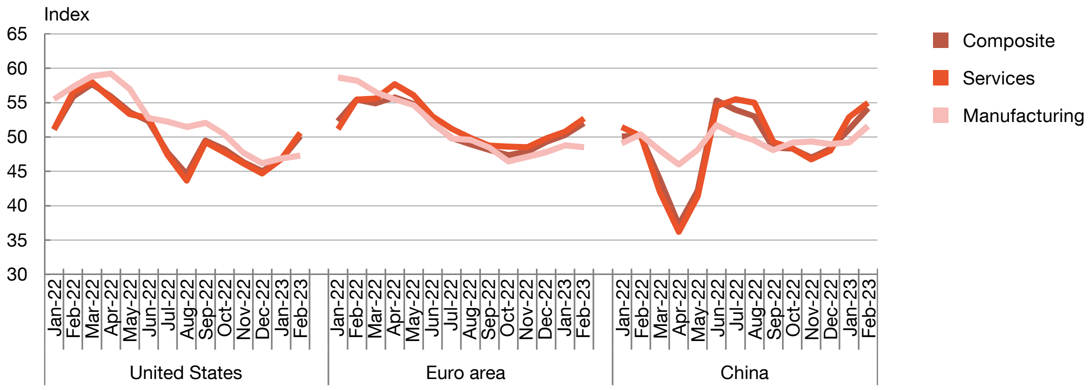
1 Global economic outlook for 2023 slightly less gloomy

— Global economic activity continued to slow down in the final months of 2022. This was particularly visible in global trade. However, the deceleration was less steep than expected a few months ago, partly as a result of energy prices surprising on the downside, global supply chain bottlenecks continuing to improve and a change in trend in the main confidence indicators (see Chart 1.a).

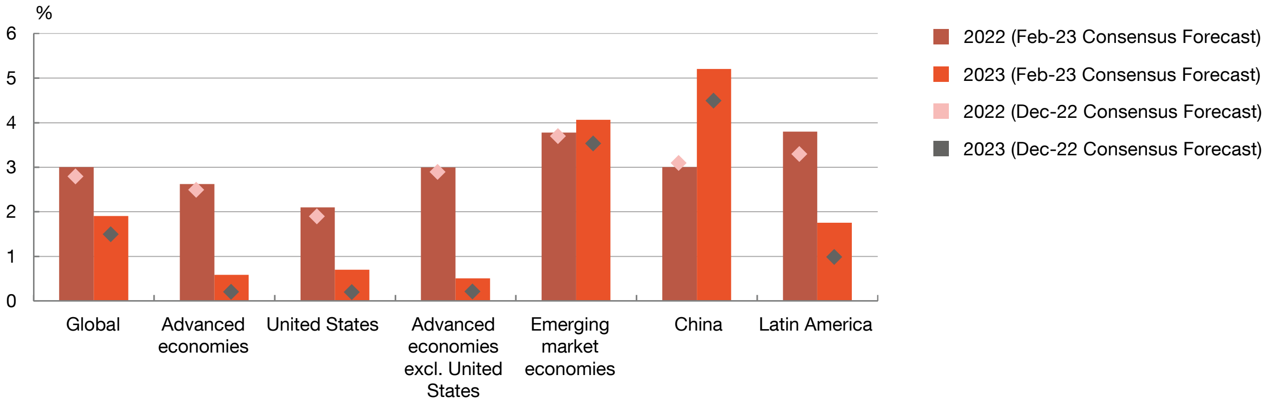
— These favourable dynamics continuing in early 2023, together with the reopening of the Chinese economy after it abandoned its zero-COVID policy – which only weighed on economic activity in China temporarily –, has led most analysts (including the International Monetary Fund and the European Commission) to revise up their growth projections for 2023, especially in the United States and China (see Chart 1.b). Even so, global economic growth is still expected to slow down significantly compared with 2022. The deceleration is projected to be particularly sharp in the advanced economies.

Chart 1

1.a Purchasing Managers' Indices



1.b GDP growth forecasts, by geographical area (a)



SOURCES: Consensus Forecasts and S&P Global.

a "Advanced economies" comprises 13 geographical areas: Canada, Czech Republic, Denmark, euro area, Iceland, Israel, Japan, Norway, South Korea, Sweden, Switzerland, United Kingdom and United States. "Emerging market economies" comprises 13 economies from Asia, eastern Europe and Latin America: China, India, Indonesia, Malaysia, Thailand, Hungary, Poland, Russia, Brazil, Chile, Colombia, Mexico and Peru.

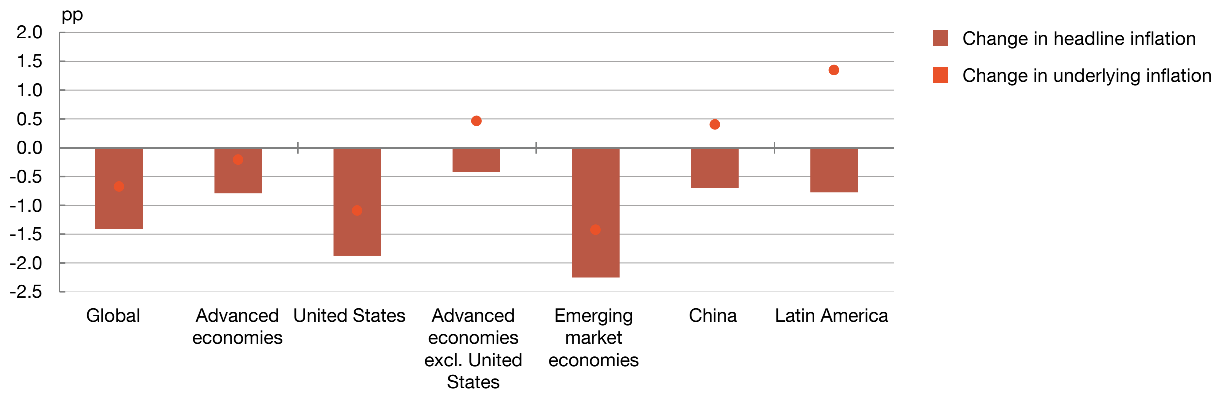
2 Headline inflation has moderated in the world's main economies, essentially on account of lower energy commodity prices

— Headline inflation has fallen globally in recent months, mainly because of energy commodity prices easing and supply chain bottlenecks gradually improving. However, this slowdown in headline inflation – which remains at high rates – has barely passed through to underlying inflation (see Chart 2.a).

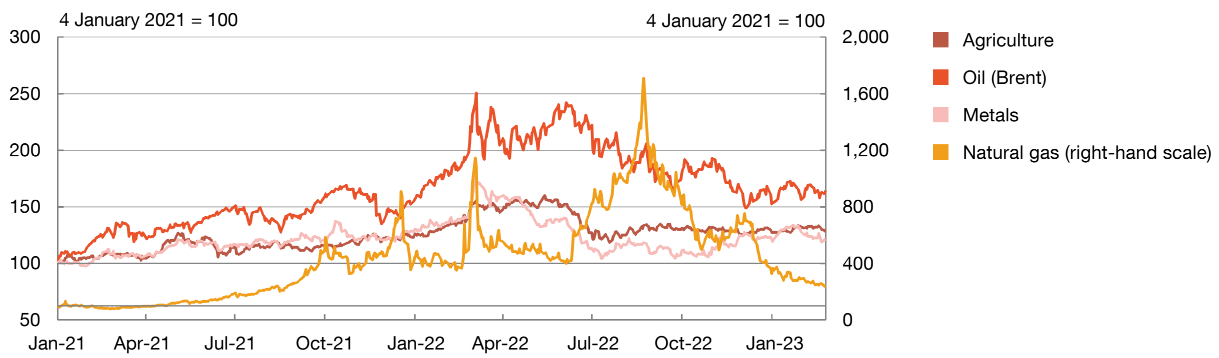
— On European commodity markets, the price of natural gas has fallen significantly in recent months, due partly to a particularly mild winter, lower consumption and the diversification of supply sources (see Chart 2.b). Oil prices have also decreased in this period, although less than natural gas prices. Meanwhile, metal prices have risen in recent months – essentially as a result of the improved growth outlook for China, whose economy accounts for a high share of global demand for these inputs –, albeit relatively moderately.

Chart 2

2.a Change in headline and underlying inflation between September 2022 and January 2023 (a)



2.b Commodity prices



SOURCES: National statistics and Refinitiv.

a "Global" comprises China, Czech Republic, euro area, Hong Kong, Hungary, India, Indonesia, Japan, Malaysia, Russia, Singapore, South Korea, Taiwan, Thailand, Turkey, United Kingdom and United States, as well as "Latin America" (comprising Brazil, Chile, Colombia, Mexico and Peru). "Advanced economies" comprises Canada, euro area, Japan, Norway, Sweden, Switzerland, United Kingdom and United States.

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3 China abandoning the zero-COVID policy will boost its economic growth in 2023 and could impact global inflation in different ways

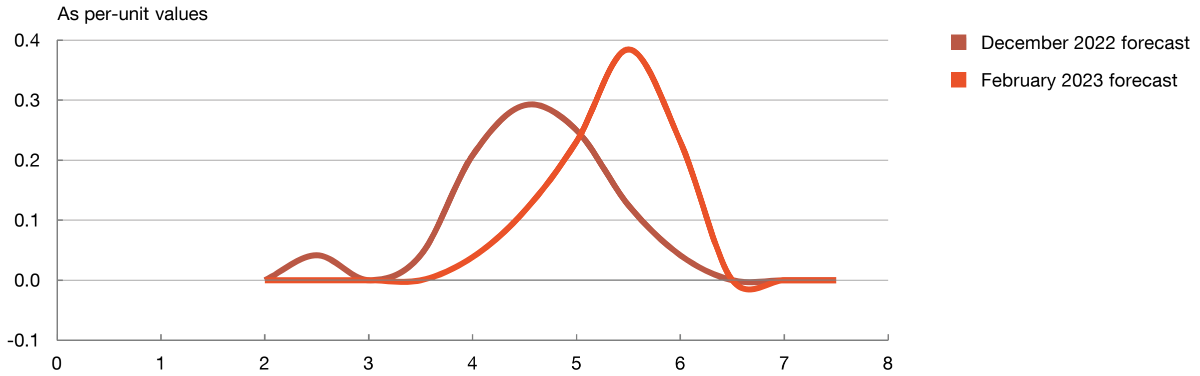
— The Chinese authorities abandoned zero-COVID in early December 2022. This translated into a surge in infections and steep drops in mobility, prompting some production chain disruptions and a downturn in activity.

— However, the latest data point to a swift improvement both in the epidemiological situation and in mobility and economic activity in recent weeks. In light of these dynamics, the growth forecast for China in 2023 has recently been revised upwards significantly (see Chart 3.a). Meanwhile, projected inflation has also been revised up, albeit more moderately.

— The impact of the reopening of the Chinese economy on global inflation is one of the main sources of uncertainty at the present juncture. On the one hand, higher growth in China would boost global demand, especially for commodities, which would tend to drive inflation rates up. On the other, China's reopening may quicken the disappearance of the global production chain bottlenecks and strengthen the capacity of global supply to meet demand, which would partially ease the current high inflationary pressures. Which of the two channels will dominate and by what margin is, for the time being, highly uncertain and will depend, among other factors, on the breakdown of the economic recovery in China itself.

Chart 3

3.a Density function of the Consensus Forecasts for Chinese GDP in 2023 (a)



SOURCES: Consensus Forecasts and Banco de España.

a The density function was estimated by calculating the proportion of the forecasts standing within a certain range, considering intervals of 0.5 pp.

4 The world's main central banks continue to tighten their monetary policies

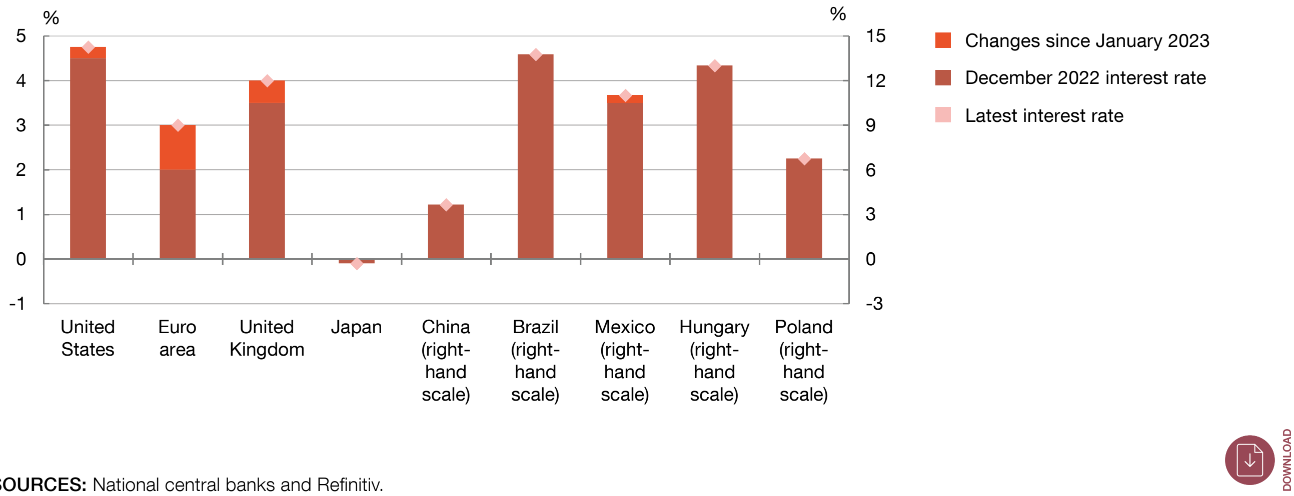
— In response to the high inflationary pressures, the central banks of the main developed economies have continued to raise their policy interest rates in early 2023. However, in some cases, they have reduced the pace of interest rate hikes compared with the last round carried out in 2022 (see Chart 4.a).

— For instance, the European Central Bank (ECB) raised its key interest rates by 50 basis points (bp) at its February and March meetings, taking the deposit facility rate to 3%. The Federal Reserve Board decreased the size of its hikes – compared with the last increases of 2022 – to 25 bp in February and raised its target range to 4.50-4.75%, while the Bank of England raised the Bank Rate by 50 bp, to 4%, in February.

— In the emerging market economies – which had launched their monetary tightening cycle before the advanced economies –, policy interest rates have not undergone significant changes in recent months.

Chart 4

4.a Policy interest rates



SOURCES: National central banks and Refinitiv.

5 International financial markets have been conditioned by inflation developments, more-resilient-than-expected activity and, more recently, the uncertainty over the situation of some banks globally

— In recent months, and in response to the different price and activity indicators that have been published, there has been a gradual shift in expectations for how quickly the world's main central banks will tighten monetary policy in the future. In this respect, as a result of a less pronounced slowdown in activity than had been expected and more persistent underlying inflationary pressures, in early March the expectations were for sharper and longer-lasting monetary policy tightening than anticipated at the start of the year. However, over the last few days these expectations have partially reversed due to the uptick in risk aversion and volatility prompted by the recent financial tensions in the international banking sector.

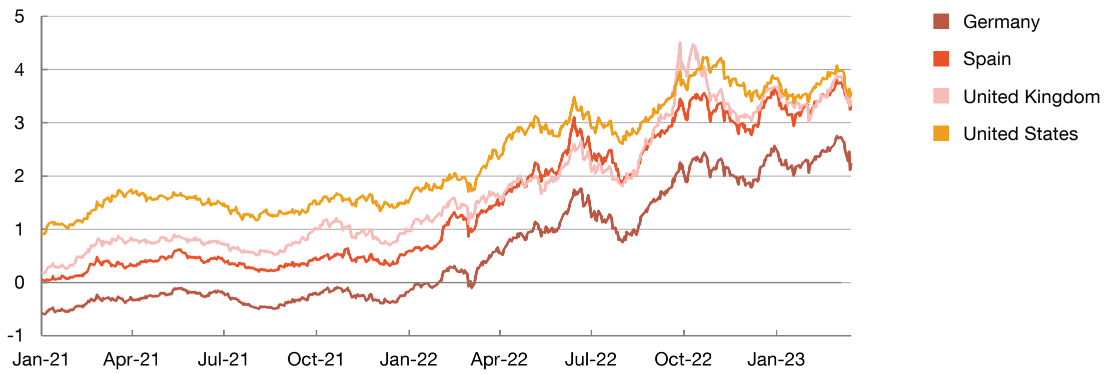
— As a result of the recent correction on the financial markets, at the cut-off date of this report, higher-rated long-term sovereign bond yields stood below their end-2022 levels (see Chart 5.a). Meanwhile, since end-December, the yield spread between European and German long-term sovereign bonds has scarcely changed for Greece and Spain, but has narrowed for Italy and Portugal (by 22 bp and 9 bp, respectively).

— Despite being adversely affected by the changes in monetary policy expectations since February and by the uncertainty surrounding the banking sector in March, most of the main global stock market indices have recorded gains in the quarter.

— In the foreign exchange market, the euro has depreciated slightly against the US dollar. For its part, the nominal effective exchange rate of the euro, defined as the weighted average of the bilateral euro exchange rates against the currencies of the euro area's trading partners, stands close to end-2022 levels.

Chart 5

5.a 10-year sovereign bond yields



SOURCE: Refinitiv Datastream.

6 In the euro area, the strength of activity has surprised on the upside in recent months, which has prompted an upward revision to the growth forecasts for 2023…

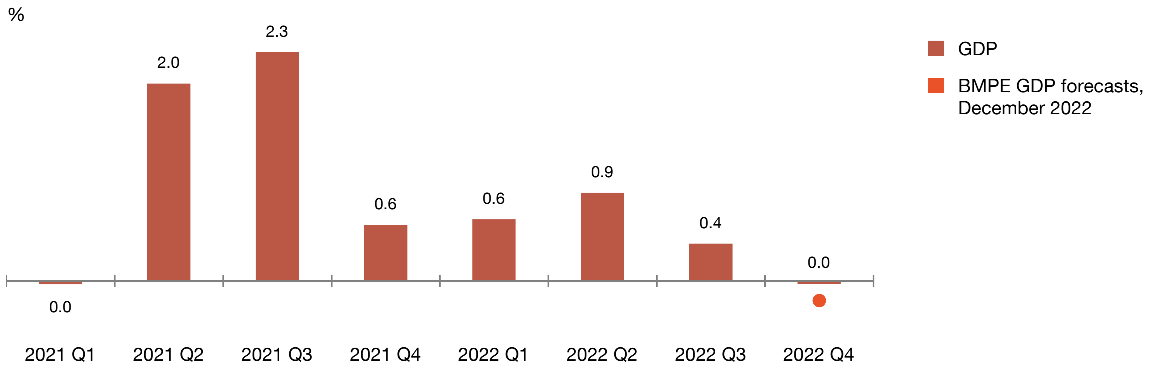
— GDP growth continued to decelerate in the euro area in 2022 Q4, essentially as a result of weak domestic demand and consumption, although the expected contraction in activity failed to materialise (see Chart 6.a).

— This positive surprise, along with the favourable developments in energy prices and various activity indicators – among others, confidence indicators – in early 2023, has meant that most analysts have recently revised up their GDP growth forecasts for the euro area in 2023 (see Chart 6.b). For instance, in the ECB's March projection exercise, euro area GDP is expected to grow by 1% in 2023, significantly more than the 0.5% envisaged in the December exercise.

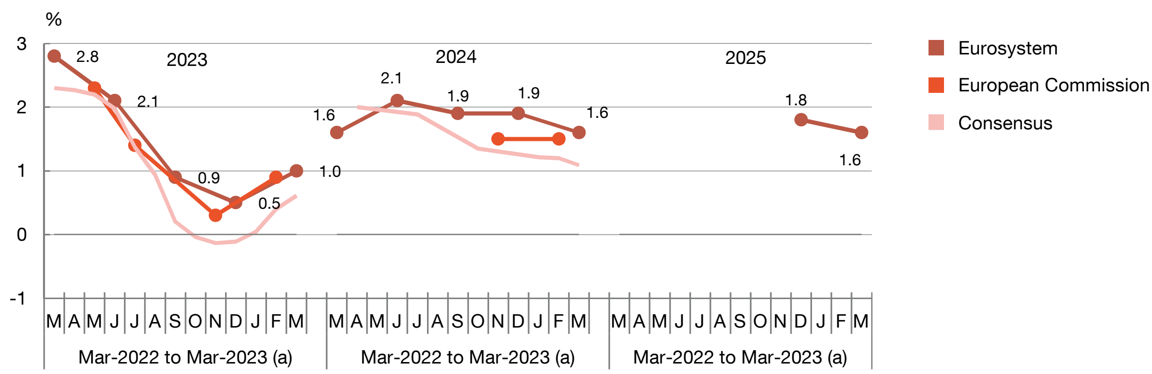
— By contrast, GDP growth in 2024 and 2025 could be somewhat weaker than projected in December (increasing by 1.6% in both years), owing in particular to a sharper tightening of financial conditions than was expected at that time, as a result of a tighter monetary policy stance.

Chart 6

6.a Euro area GDP growth path (quarterly rate of change)



6.b Euro area GDP growth forecasts



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

a The letters refer to the months when the respective forecasts were published.

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7 … in a setting in which headline inflation has eased, on the back of lower energy prices, while underlying and food inflation both remain high

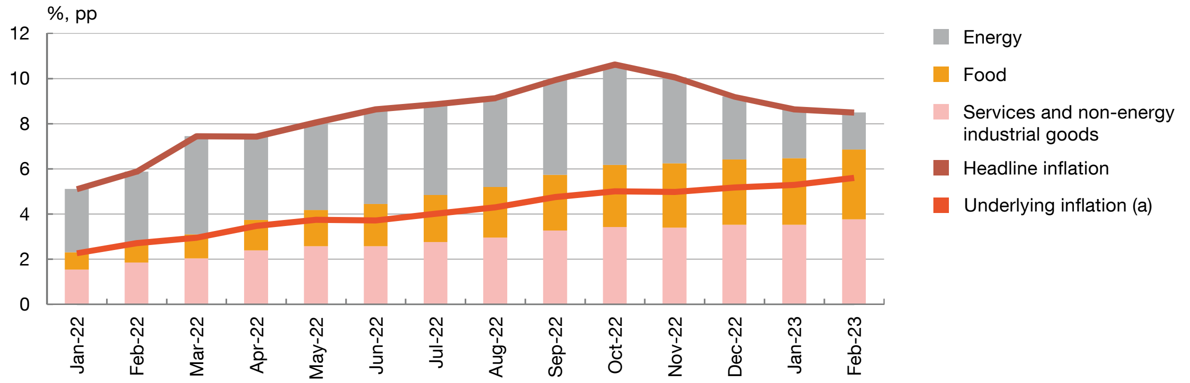
— Euro area inflation stood at 8.5% in February. This was lower than forecast and 2 percentage points (pp) off its October 2022 peak of 10.6%. This correction was underpinned exclusively by energy prices, as both underlying and food inflation continued to climb, with growth rates of 5.6% and 15%, respectively, in February (see Chart 7.a).

— Having incorporated these latest trends into its March projection exercise, together, among other factors, with the expected developments for energy prices and financial conditions (with the former expected to be lower and the latter to be somewhat tighter than in the December exercise), the ECB has revised down its baseline scenario for headline inflation over the whole projection horizon. In particular, average inflation rates are expected to reach 5.5% in 2023, 2.9% in 2024 and 2.1% in 2025, 1 pp, 0.5 pp and 0.2 pp, respectively, below the December forecasts (see Chart 7.b).

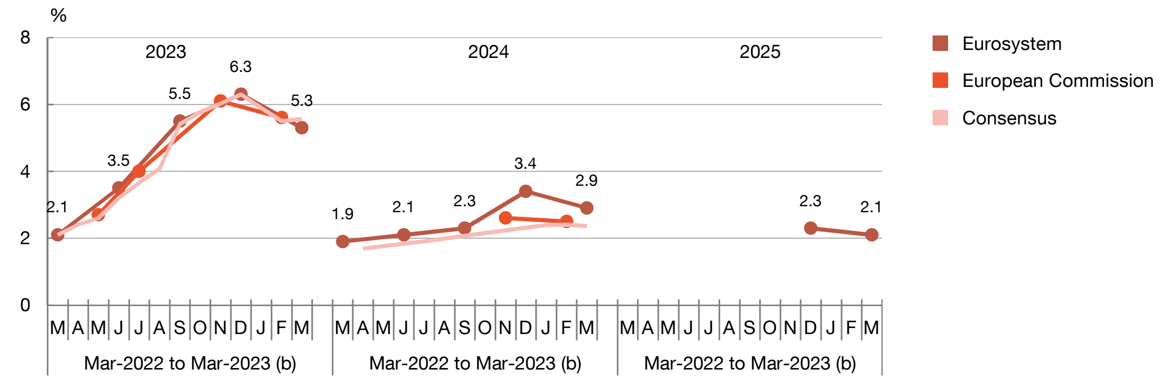
— In any event, the ECB's March projection exercise continues to point to what are still very high inflationary pressures in the underlying component. Specifically, the average underlying inflation rate is expected to climb to 4.6% in 2023 (from 3.9% recorded in 2022), before falling to 2.5% in 2024 and to 2.3% in 2025.

Chart 7

7.a Euro area inflation and contribution of components



7.b Euro area inflation forecasts



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

a Headline HICP excluding energy and food.
b The letters refer to the months when the respective forecasts were published.

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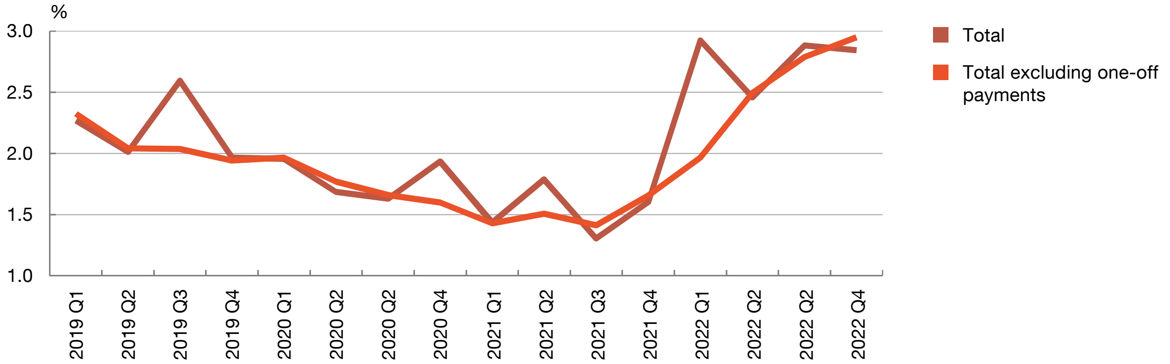
8 The uncertainty surrounding the euro area growth and inflation projections remains very high

— Among the main risk factors, the first is the uncertain course of the war in Ukraine and its implications for uncertainty and for commodity supplies and prices. The second is the recent financial market stress, which could further tighten global financial conditions and affect agents' confidence. There is also considerable uncertainty surrounding the implications for activity and inflation worldwide as a result of the reopening of the Chinese economy.

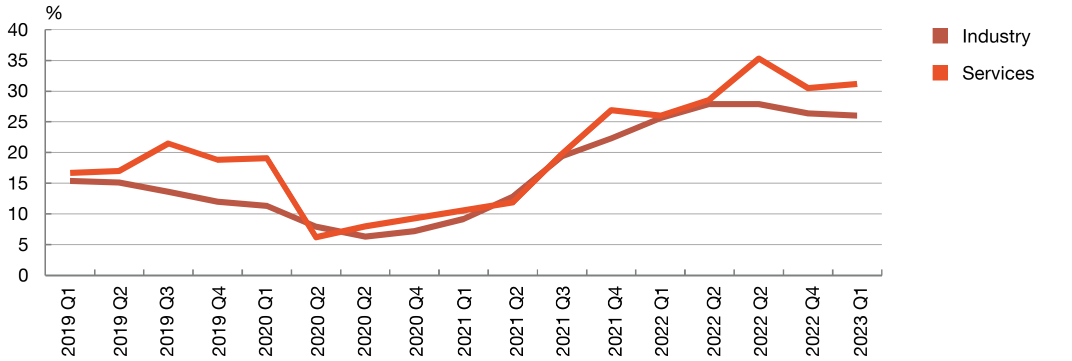
— On the domestic front, the recent upside surprises in underlying price inflation have fuelled doubts as to the persistence of inflation, in a setting in which higher costs may not yet have fully passed through to consumer prices. This is countered by the disinflationary effects of the recent fall in some commodity prices. But the risks of second-round effects on inflation have not been dispelled. In this respect, wage increases could be higher than expected, given the relative strength of the labour market (see Charts 8.a and 8.b).

Chart 8

8.a Euro area wage settlements. Year-on-year rates of change



8.b Euro area tight labour market conditions, by sector (a)



SOURCES: ECB and European Commission.

a Percentage of firms for which labour is a production constraint.

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9 The ECB has continued to raise its key interest rates and has emphasised that it stands ready to respond as necessary to preserve price stability and financial stability in the euro area

— Continuing with its monetary policy tightening, at its March meeting the ECB's Governing Council raised its key interest rates by 50 bp, taking the deposit facility rate to 3%. This is a cumulative increase of 350 bp since July 2022 (see Chart 9.a).

— Given the high level of uncertainty, future interest rate decisions will be data dependent and will be determined by the Governing Council's assessment of the inflation outlook in light of the new economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission.

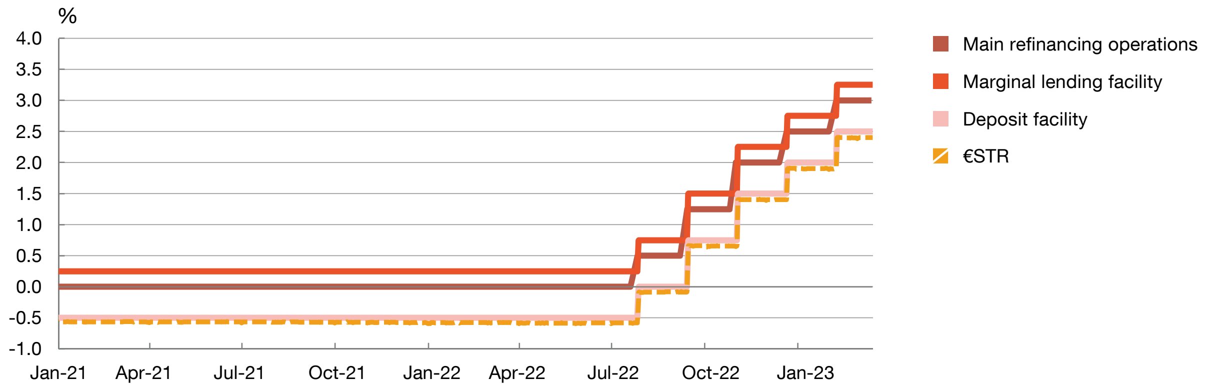
— Moreover, the Governing Council is closely monitoring the current financial market tensions and stands ready to respond as necessary to preserve price stability and financial stability in the euro area.

— It has also underlined that the euro area banking system is resilient, with strong capital and liquidity positions. In any event, the ECB's monetary 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 addition, the ECB's asset purchase programme (APP) portfolio is now declining at a measured and predictable pace of €15 billion per month on average. This rate of decline will continue up to the end of June 2023, with the subsequent pace to be determined over time.

Chart 9

9.a Key ECB interest rates and €STR



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SOURCES: Banco de España and Refinitiv Datastream. Latest data: 15/3/2023.

10 In Spain, GDP growth was higher than expected in 2022 overall, although the momentum declined as the year unfolded

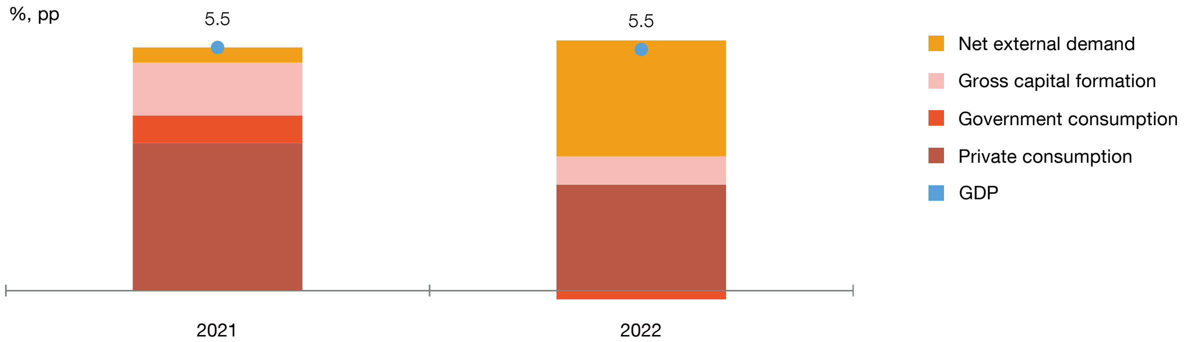
— According to the latest information published by the National Statistics Institute (INE, by its Spanish abbreviation), GDP rose by 5.5% in Spain in 2022, matching the rate of growth recorded in 2021 and above the 4.6% envisaged in the Banco de España's December macroeconomic projections.[1]

— The GDP breakdown shows that net external demand and private consumption were the main growth drivers in 2022, both linked to the end of the restrictions on mobility – once the worst phases of the pandemic were over – and the recovery in tourism and leisure activities (see Chart 10.a). Consistent with these developments, market services accounted for most of the supply-side growth in 2022.

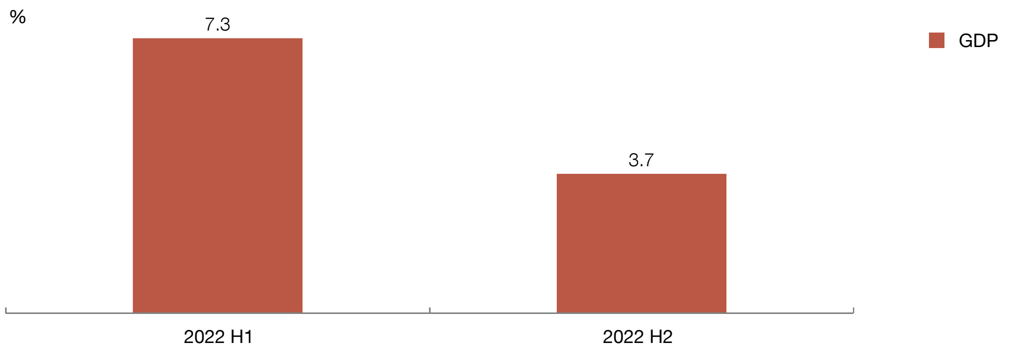
— In any event, the strong dynamism of activity in 2022 overall masked two very different half-year periods, as GDP grew by 7.3% year-on-year in the first half, but by just 3.7% in the second (see Chart 10.b).

Chart 10

10.a Spanish GDP, average growth in 2021 and 2022



10.b Spanish GDP, year-on-year growth in 2022 H1 and H2



SOURCES: Banco de España and INE.

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1 See Banco de España. (2022). "Box 1. Macroeconomic projections for the Spanish economy (2022-2025): the Banco de España's contribution to the Eurosystem's December 2022 joint forecasting exercise". In "Quarterly report on the Spanish economy". *Economic Bulletin - Banco de España,* 4/2022.

11 Output growth was relatively modest in 2022 Q4, although it surprised slightly on the upside

— Spanish GDP rose by 0.2% quarter-on-quarter in 2022 Q4, similar to the growth rate observed in Q3 and slightly above the 0.1% forecast in the Banco de España's December projection exercise (see Chart 11.a).

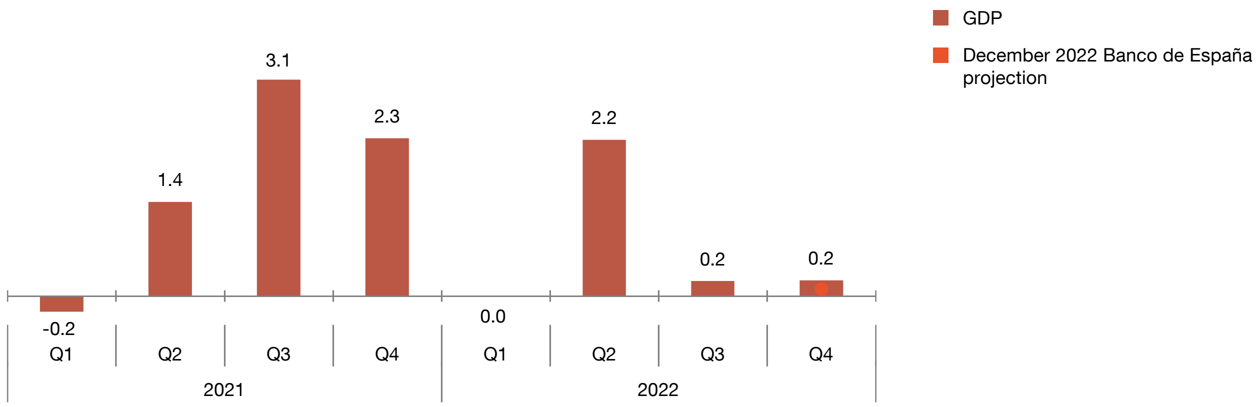
— According to the National Statistics Institute's (INE) flash estimate, economic growth in 2022 Q4 was driven mainly by net external demand, whose contribution totalled 1.1 pp, reflecting the sharper fall in imports than in exports. Meanwhile, the weakness of private consumption and investment meant that domestic demand made a negative contribution to growth (-0.9 pp).

— On the supply side, the sectors that contributed most to GDP growth in the final stretch of 2022 were the primary sector and the information and communication sector, while arts and recreation services and other service activities showed greater weakness, despite having seen very strong gains in previous quarters and having reached levels of activity in September very close to their pre-pandemic levels. Nonetheless, Spanish GDP at end-2022 was still 0.9 pp below its end-2019 level, while in the euro area as a whole GDP stood slightly more than 2 pp above that reference level.

Chart 11

11.a Spanish GDP

Quarter-on-quarter rate of change, %



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SOURCES: Banco de España and INE.

12 The available indicators for 2023 Q1 suggest that GDP has grown in the quarter at a pace similar to that of the closing months of 2022

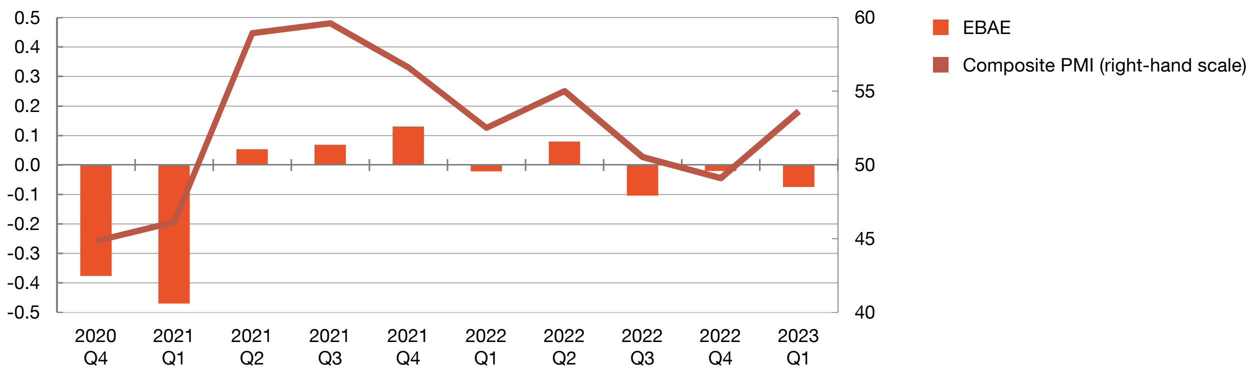
— An overall analysis of the various indicators (including employment, consumption and confidence indicators) that provide partial, and as yet incomplete, information on the performance of activity in 2023 Q1 suggests that Spanish GDP could grow in this period by 0.3% quarter-on-quarter. Nonetheless, there is considerable uncertainty surrounding this estimate.[2]

— Of note among the available indicators are the PMIs, which in January and February were higher, on average, than in the last two quarters of 2022 (see Chart 12.a).

— Meanwhile, the results of the Banco de España Business Activity Survey (EBAE) suggest that the weakness in activity seen in 2022 H2 has continued throughout 2023 Q1 (see Chart 12.a), although firms now expect a smaller decline in turnover for the current quarter than they did three months ago.[3]

Chart 12

12.a Turnover according to the EBAE and the composite PMI (a) (b)



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

a The qualitative responses from the EBAE are converted into a numerical scale as follows: significant decrease = –2; slight decrease = –1; stable = 0; slight increase = 1; significant increase = 2.
b The composite PMI figure for 2023 Q1 is the average of January and February.

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

3 For more details, see Alejandro Fernández and Mario Izquierdo. (2023). “Encuesta a las empresas españolas sobre la evolución de su actividad: primer trimestre de 2023”. *Boletín Económico - Banco de España,* 2023/T1, 21. https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/23/T1/Fich/be2301-art21.pdf

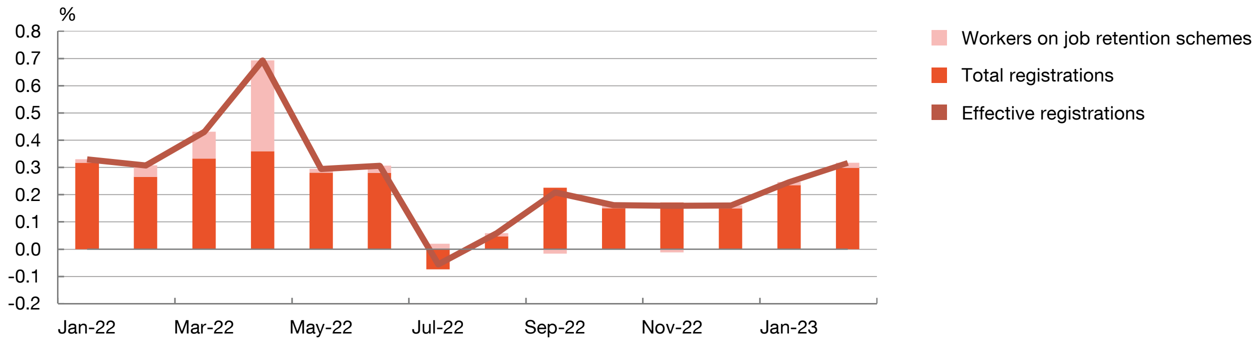
13 Job creation accelerated at the beginning of 2023 amid a decrease in the number of hours worked per worker

— Seasonally adjusted month-on-month growth in social security registrations was 0.2% in January and 0.3% in February. Both these rates were higher than those observed in the closing months of 2022 (see Chart 13.a). According to the information available for the first half of the month, employment growth appears to have intensified in March. This pick-up in employment – which was higher than expected – was observed across almost all economic sectors, with social security registrations performing particularly well in the construction sector in January and in services in February.

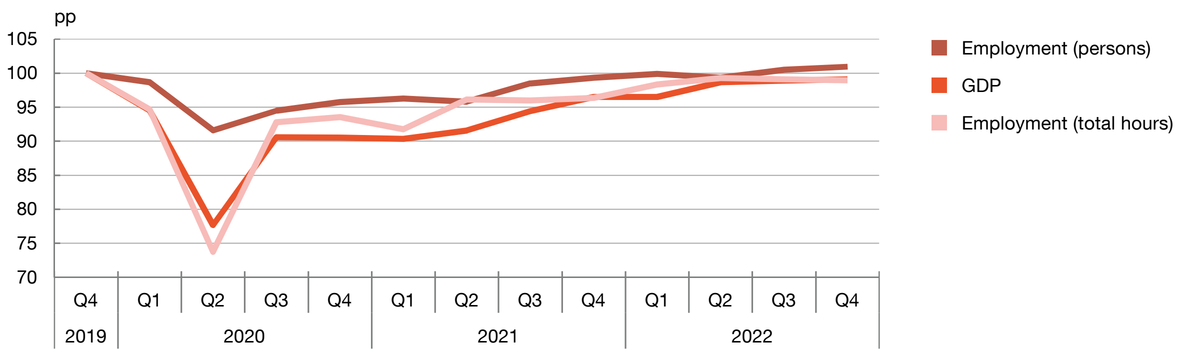
— The latest National Accounts information points to a slight decline in the number of hours worked in 2022 H2, in contrast with the relative buoyancy of employment in terms of persons employed in that same period (see Chart 13.b). Thus, the number of hours worked per worker decreased in 2022 H2, in line with the downward trend seen in Spain's average working day over the last few decades.[4]

Chart 13

13.a Total social security registrations, workers on job retention schemes and effective social security registrations (a)



13.b GDP and employment since the onset of the pandemic (2019 Q4 = 100)



SOURCES: Quarterly National Accounts (INE), Ministerio de Inclusión, Seguridad Social y Migraciones and Banco de España.

a Seasonally adjusted monthly rate.

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4 For a more detailed analysis, see Pilar Cuadrado. (2023). "An analysis of hours worked per worker in Spain: trends and recent developments". *Economic Bulletin - Banco de España,* 2023/Q1, 14. https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/23/T1/Files/be2301-art14e.pdf

14 Financial conditions in Spain have continued to tighten, with a slight contraction in the volume of new lending in recent months

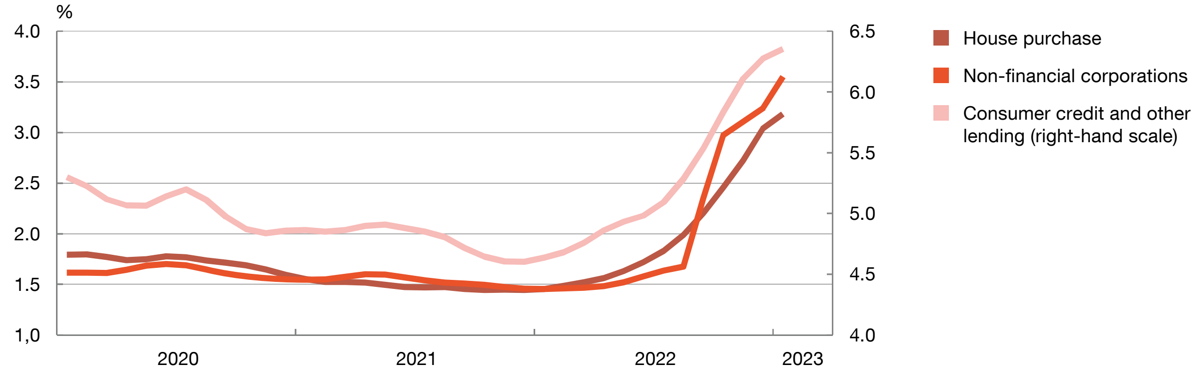
— The pass-through of higher market interest rates to the cost of new bank loans has gathered pace across all segments in recent months (see Chart 14.a). In particular, the cost of new bank loans in the corporate and house purchase segments is already similar to euro area levels, while in the consumer credit and other lending segment this cost is higher than that observed in the euro area.

— According to the Bank Lending Survey, credit standards in 2022 Q4 tightened across the board in Spain for the third quarter in a row, albeit less than anticipated by banks a quarter earlier. Meanwhile, loan demand fell in the two household segments (house purchase, and consumer credit and other lending), while demand from firms grew slightly, driven by their greater financing needs for working capital and inventories. For 2023 Q1, banks once again expect loan supply to contract and loan demand to fall across the board.

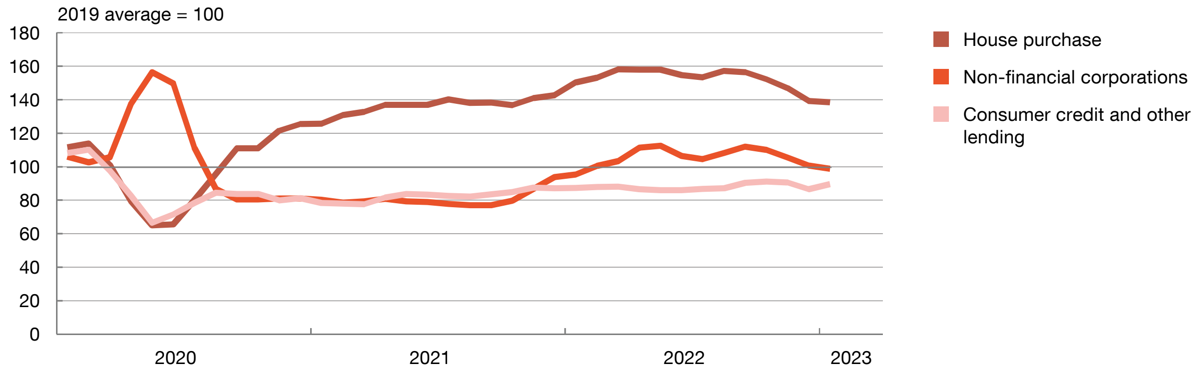
— Together, these developments have contributed to a slight contraction in the volume of new lending to households and firms in recent months (see Chart 14.b).

Chart 14

14.a Cost of new bank lending (a)



14.b New lending: 3-month cumulative seasonally adjusted flows



SOURCE: Banco de España.

a Bank interest rates are narrowly defined effective rates (NDER) and are adjusted seasonally and for the irregular component.

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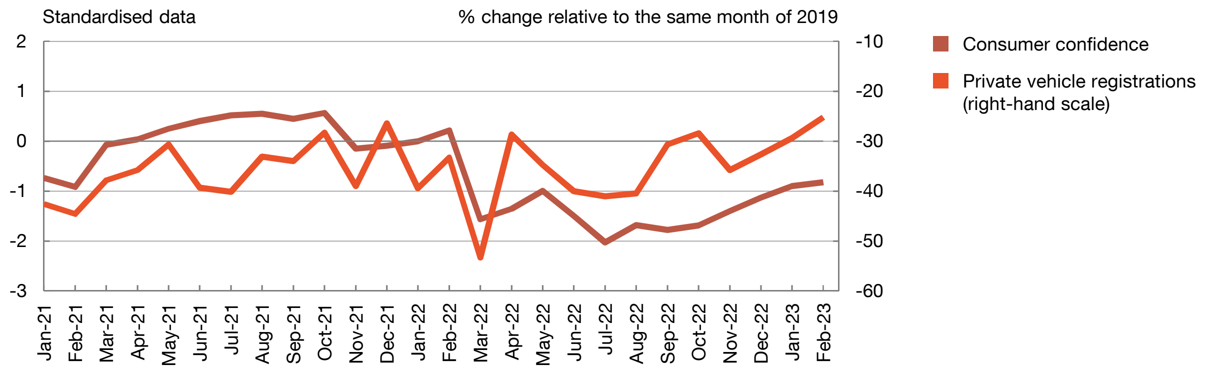
15 Household consumption appears to have remained quite weak in early 2023

— Improved confidence, the pick-up in job creation and several recent indicators (such as private vehicle registrations to February) suggest that household consumption could have been more buoyant in early 2023 than in 2022 Q4 (see Chart 15.a).

— In any event, this demand component remains rather weak, penalised by still high inflationary pressures, the continued tightening of financial conditions – whose effects on real activity have not yet fully materialised – and the lower savings buffers available.

Chart 15

15.a Household spending indicators (a)



SOURCES: European Commission, ANFAC and Banco de España.

a Standardised data 2000-2019.

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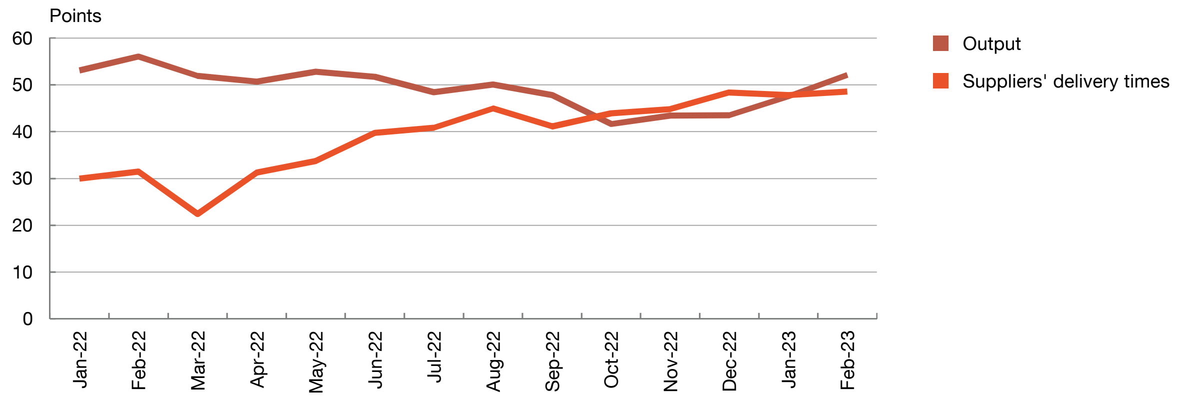
16 Business investment could rise slightly in the first few months of the year

— Although business investment displayed significant weakness throughout 2022 and some factors – such as the tightening of financial conditions and still-high levels of uncertainty – will continue to limit its future growth substantially, from a short-term perspective some recent indicators may hint at a modest upswing in business investment in the first few months of 2023.

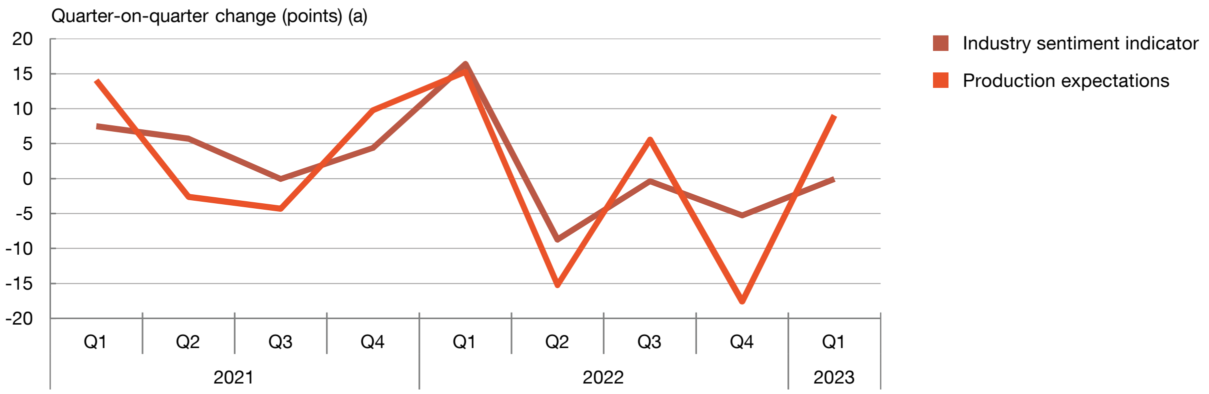
— In particular, this appears to be suggested by the fall in delivery times, the changes in the PMI indicators in January and February (see Chart 16.a), improved expectations for future activity (see Chart 16.b) and the gradual roll-out of the NGEU projects.

Chart 16

16.a Manufacturing PMIs



16.b Confidence indicators in the capital goods industry



SOURCES: IHS Markit and European Commission.

a Latest available observation: February 2023.

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17 Housing investment seems to have continued to decelerate in Q1 against a backdrop of rising costs of loans for house purchase

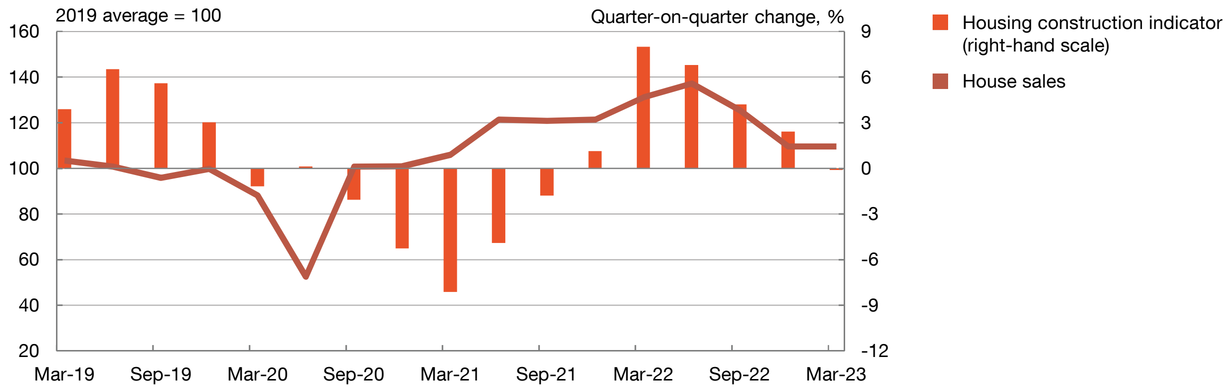
— Both the pace of housing construction and house sales continued to decline, a pattern that dates back to 2022 Q2 (see Chart 17.a).

— These developments, influenced by tightening financing conditions in recent months, which already appear to have caused a drop in new lending for house purchase, seem to point to a further slowdown in housing investment in 2023 Q1.

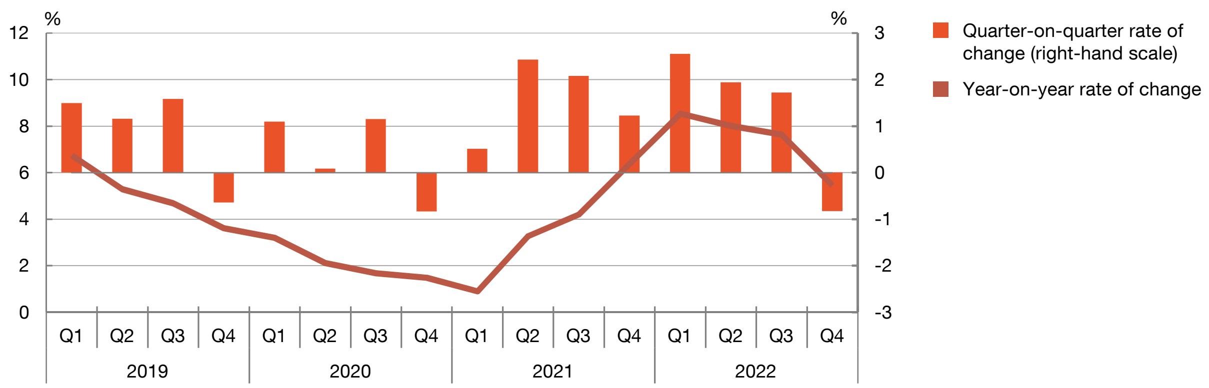
— Furthermore, although house prices have been relatively strong recently owing, in part, to supply-side constraints, the latest data suggest some slackening. In particular, house prices increased by 5.5% year-on-year in 2022 Q4, a 2.1 pp drop from 7.6% in Q3, resulting in a drop of 0.8% in house prices in quarterly terms (see Chart 17.b).

Chart 17

17.a Housing construction indicator and house sales (a)



17.b House prices



SOURCES: Banco de España, Centro de Información Estadística del Notariado, INE and Ministerio de Transportes, Movilidad y Agenda Urbana.

a Seasonally adjusted series for house sales. The latest observed data correspond to January 2023 for house sales, whose seasonally adjusted value is taken to represent 2023 Q1 as a whole. For the housing construction indicator, the time frame considered is three months from issue of the building permit to the construction start date and 18 months thereafter for the construction work; the latest data for this quarterly indicator correspond to 2023 Q1.

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18 Net exports' contribution to output growth appears to have moderated in Q1, following their significant contribution in late 2022

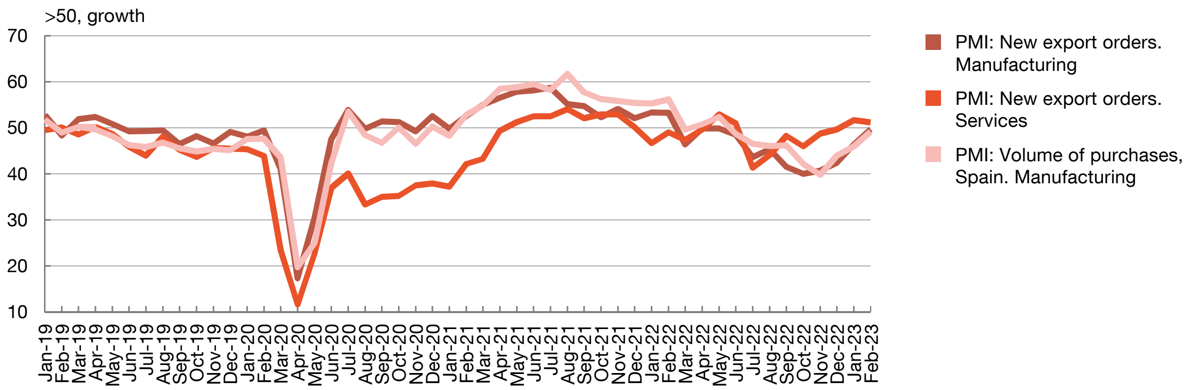
— The projected performance of external markets in 2023 Q1 and the recovery of the PMI indicators for new export orders up to February (see Chart 18.a) point to a slight uptick in goods exports in the early months of this year amid the gradual easing of bottlenecks in global supply chains.

— However, the expected rebound in business investment – with a high import content – and the emerging appreciation of the euro against the currencies of major trading partners could drive demand for imports following the weakness seen towards the end of 2022, which could reduce the contribution of net exports to GDP growth in 2023 Q1. The PMI indicators for January and February for volume of purchases in Spain, for example, point in this direction (see Chart 18.a).

— As for international tourism, the vigour shown by foreign expenditure in recent quarters (which partly reflects a larger share of higher-quality tourism)[5] appears to have led, in nominal terms, to the cumulative travel surplus in 2022 standing 6.7% above its 2019 level.

Chart 18

18.a Purchasing managers' indices



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SOURCE: Markit.

5 See Coral García Esteban, Ana Gómez-Loscos and César Martín-Machuca. (2023). "The recovery of international tourism in Spain after the pandemic". *Economic Bulletin – Banco de España*, 2023/Q1, 08. https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/23/T1/Files/be2301-art08e.pdf

19 The gradual fall in the public deficit appeared to partially reverse in the closing months of last year owing to the slowdown in government revenue

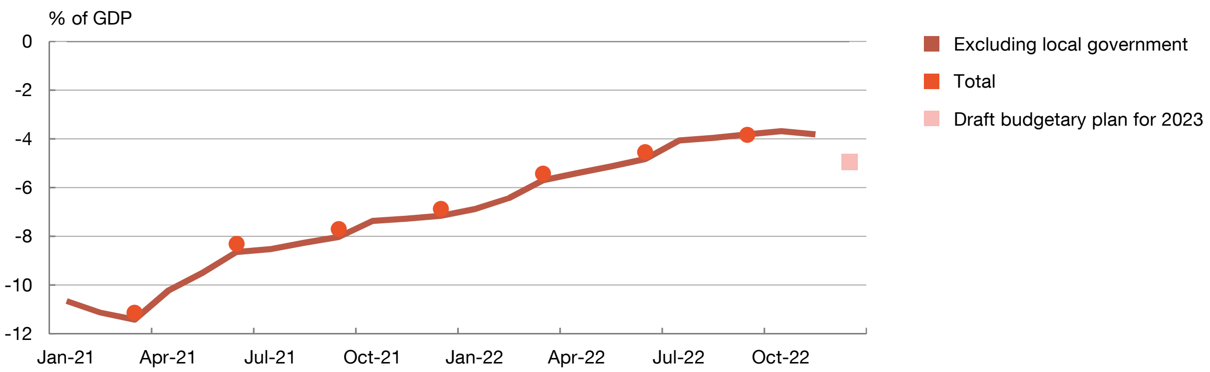
— In November, the latest month for which the IGAE has published data, the 12-month cumulative general government balance stood at -3.8% of GDP, equal to that of September and above the -5.0% forecast by the Government in its latest draft budgetary plan (see Chart 19.a).

— In the second half of 2022, up to November, the relative stability of spending growth stood in stark contrast to the marked slowdown seen in government receipts (see Chart 19.b). In particular, there was a notable slowdown in indirect taxes, which recorded negative year-on-year growth rates in October and November, with collection below what could be expected bearing in mind the tax cuts approved and the performance of their macroeconomic bases.[6]

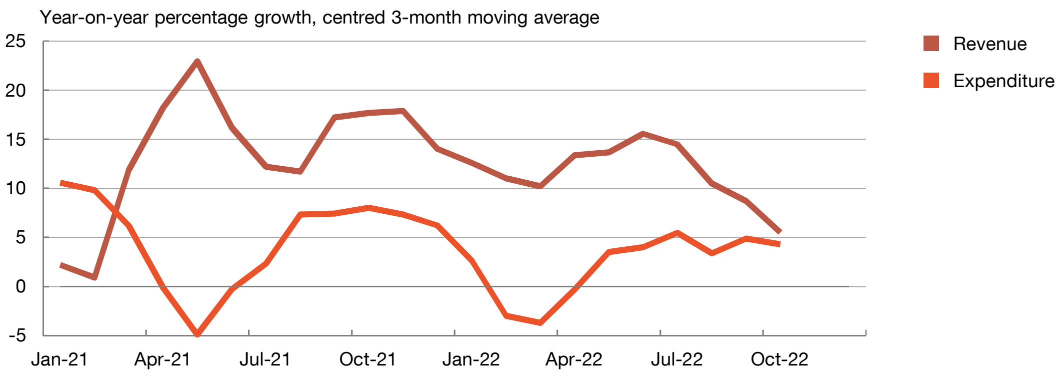
— The INE's flash estimate for 2022 Q4, while preliminary, appears to confirm the slowdown in indirect taxes, while simultaneously indicating an uptick in government consumption and subsidies in the latter part of the year.

Chart 19

19.a General government balance (a)



19.b Public revenue and expenditure (b)



SOURCES: Banco de España and IGAE.

a The National Audit Office (IGAE) only provides information on the overall general government sector on a quarterly basis.
b General government excluding both local government and transfers between different tiers of general government.

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6 This differs from the unusually positive behaviour of tax revenue in prior quarters. See Esteban García-Miralles and Jorge Martínez Pagés. (2023). "Government revenue in the wake of the pandemic. Tax residuals and inflation". *Economic Bulletin - Banco de España,* 2023/Q1, 16. https://doi.org/10.53479/29791

20 Headline inflation rose again in early 2023 as a result of some technical corrections, while the growth rate of food prices remained high …

— The downward trend that characterised headline inflation from mid-2022 (owing fundamentally to lower energy prices) was interrupted in early 2023 by a slight upswing in inflation, from 5.5% in December 2022 to 6% in February 2023 (see Chart 20.a).

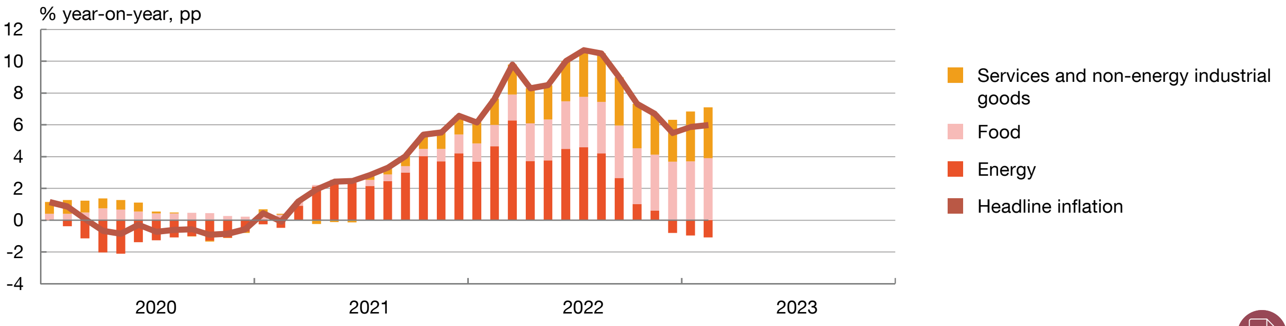
— Most of this rise is down to the impact of the general fuel discount having been limited to hauliers and other professionals in late 2022 – which appears to have lifted the year-on-year inflation rate by around 0.7 pp in January – and to several changes to the way the INE calculates the HICP as of January 2023.

— Among these changes, it is worth noting that gas and electricity prices for contracts on the free market have been incorporated into the measurement, which would have raised headline inflation in the opening months of the year by around 0.4 pp. By contrast, the annual revision of the weights, which has taken into account the reversal of changes in household consumption patterns during the pandemic, appears to have added around 0.3 pp to headline inflation in January.[7]

— Meanwhile, food price inflation accelerated slightly in early 2023 in spite of the reduction in VAT on certain basic foodstuffs introduced at the start of the year.[8] The VAT cut appears to have reduced headline inflation in January by around 0.2 pp, which would indicate that roughly 90% of the tax reduction had passed through to consumer prices.[9]

Chart 20

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



SOURCES: Eurostat and Banco de España.

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7 The changes entailed an increase in the weight of services in the consumption basket (from 40.2% to 45%) and decreases in the weights for energy (from 11.7% to 9.8%), food (from 25.1% to 23.4%) and non-energy industrial goods (from 22.9% to 21.3%). Also, from January 2023 the main source for the calculations of HICP weights was changed from the Spanish Household Budget Survey to the Spanish National Accounts, pursuant to the criteria laid down by European regulations.

8 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: bread, baking flour, milk, cheese, eggs, fresh fruit, fresh vegetables, legumes, potatoes and cereals. VAT on oil and pasta was reduced from 10% to 5%. However, if the year on-year rate of underlying inflation is less than 5.5% in March, the VAT rates on all of these products will revert to their previous level as of 1 May 2023.

9 This impact is estimated using the difference-in-differences method. To be specific, the difference is calculated between the January 2023 month-on-month percentage change of the price of each of the subtypes of food and drink affected by the measure and the average January month-on-month percentage change from 2016 to 2022. The difference between this difference for affected items and the equivalent difference for unaffected items is then calculated. See Antonio De Amores, Salvador Barrios, Raffael Speitmann and Daniel Stoehlker. (2023). Price Effects of Temporary VAT Rate Cuts: Evidence from Spanish Supermarkets. European Commission, JRC132542 for an alternative simulation with very similar results.

21 ... and underlying inflationary pressures remain high

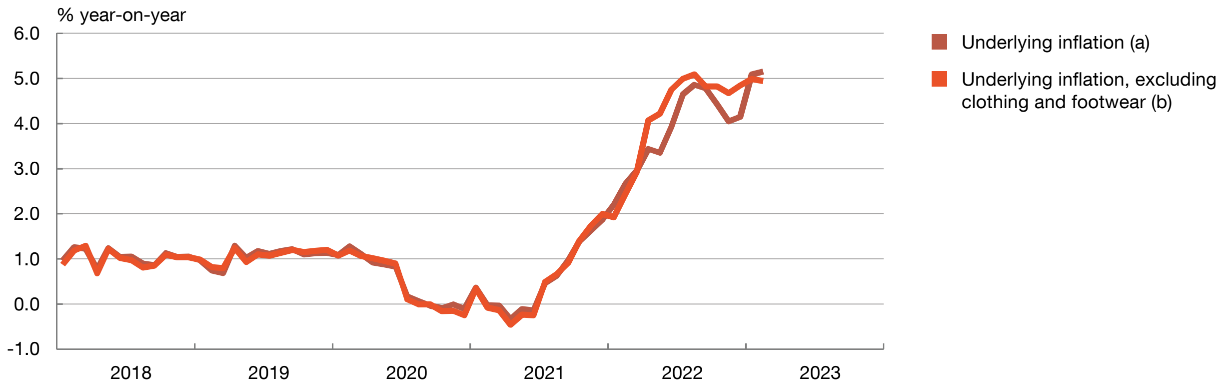
— Underlying inflation – core, excluding food and energy – reached its historical high in February, 5.2% (see Chart 21.a), despite the impact of the measures approved for transport and rentals.[10]

— In any event, the changes in underlying inflation in recent months have been highly influenced by the behaviour of clothing and footwear prices, owing to a methodological change introduced by the INE in January 2022. Excluding this component, underlying inflation has remained relatively stable since mid-2022 (see Chart 21.a).

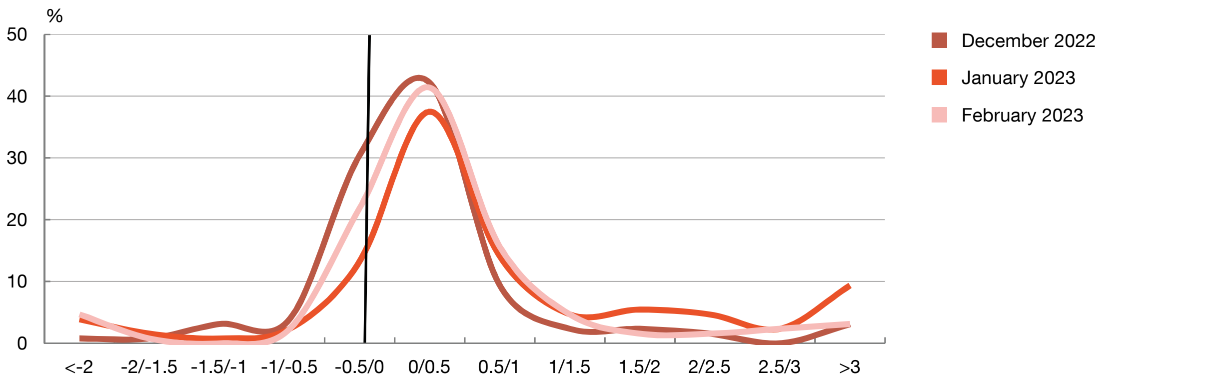
— Although the deceleration of energy costs from autumn 2022 and, more recently, of producer prices, could reduce – with some lag – underlying inflationary pressures in the coming months, in the short term, these pressures still remain very high (see Chart 21.b).

Chart 21

21.a Underlying inflation in Spain



21.b Percentage of HICP sub-classes, excluding energy and food in each range of month-on-month growth (c)



SOURCES: Eurostat and Banco de España.

a Headline inflation, excluding energy and food.
b Underlying inflation, excluding Group 03 of the ECOICOP classification (Clothing and footwear).
c Month-on-month rates corrected for average rates in the period 2016-2019, for each month.

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10 In particular, Royal Decree-Law 20/2022 of 27 December 2022, approved measures relating to discounts on certain passenger land transport tickets and extended the 2% cap on housing rent increases. Overall, these measures detracted between 0.5 pp and 0.6 pp from underlying inflation in January 2023.

22 Wages continue to increase moderately in the early months of 2023…

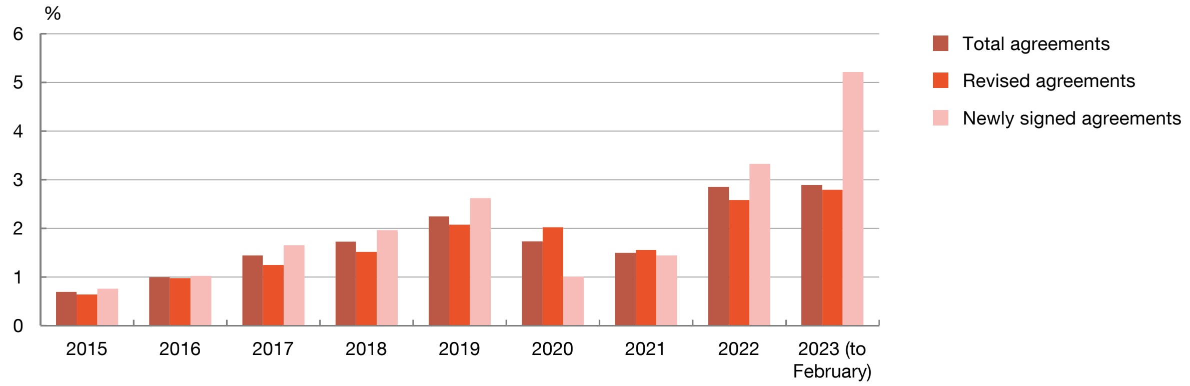
— According to the information available to February, the average negotiated wage increase under collective agreements in force in 2023 was 2.9%, in line with the increases agreed for 2022 (see Chart 22.a). However, this figure mostly reflects the increase negotiated in agreements signed in previous years, while new collective agreements signed over the course of 2022 H2 point to an average wage increase of 3.3%. For their part, collective agreements signed in the first two months of 2023 envisage an increase of 5.2%, but only affect 245,000 workers; therefore, they are not very representative.

— The prevalence of indexation clauses in the collective agreements signed for 2023 stood at 27.4%, slightly above that observed in 2022 (see Chart 22.b).

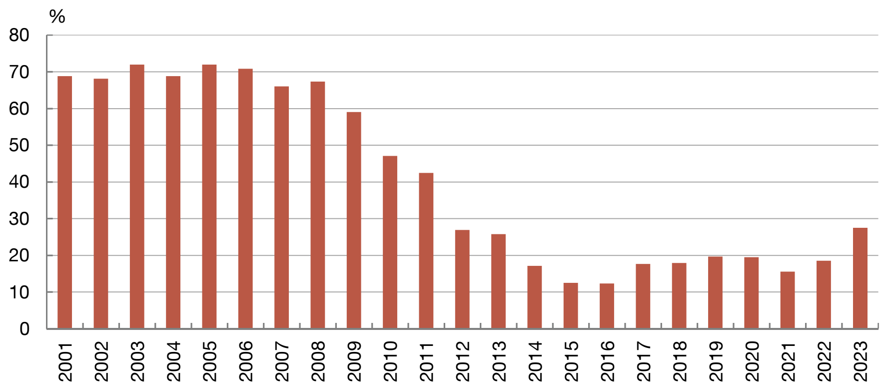
— The indexation clauses signed for 2022 seem to have led to an upward revision of the wage increases agreed that year of around 0.2 pp,[11] similar to that estimated for 2021.[12]

Chart 22

22.a Wage settlement



22.b Prevalence of indexation clauses



SOURCE: Ministerio de Trabajo y Economía Social.

11 According to the first figures published by the Ministry of Labour and Social Economy on the revised wage increase for 2022.

12 The coverage provided by indexation clauses against inflation surprises was around 40%, in line with that observed in recent years. See Mario Izquierdo and José Luis Herrera. (2022). “Box 6. Recent indexation clauses: an analysis”. In “Quarterly report on the Spanish economy”. *Economic Bulletin - Banco de España,* 3/2022, pp. 59-61. https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/22/T3/Files/be2203-it-Box6.pdf

23 … while there seems to have been a certain rebound in profit margins throughout 2022, albeit with high heterogeneity across sectors and firms

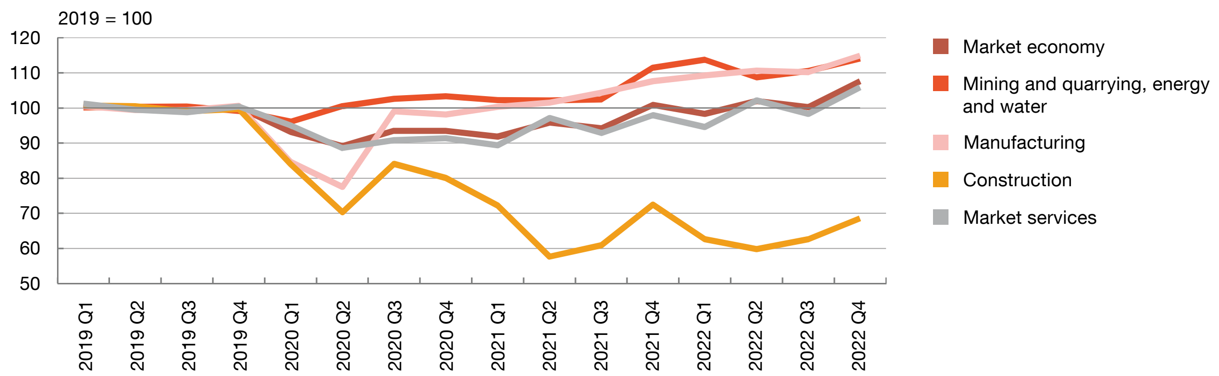
— According to the provisional National Accounts data for 2022 Q4, the ratio of gross operating surplus (GOS) to gross value added (GVA) in the market economy increased in the final stretch of 2022 to levels slightly above those recorded pre-pandemic (see Chart 23.a).

— This is consistent with the behaviour of the ratio of gross operating profit (GOP) to GVA observed, until end-2022, in the sample of firms in the Banco de España's Central Balance Sheet Data Office Quarterly Survey (CBQ). However, it should be noted that in the CBQ profit margins approximated as the ratio of GOP to turnover remained practically stable in 2022 and are still below the level recorded in 2019 (see Chart 23.b).

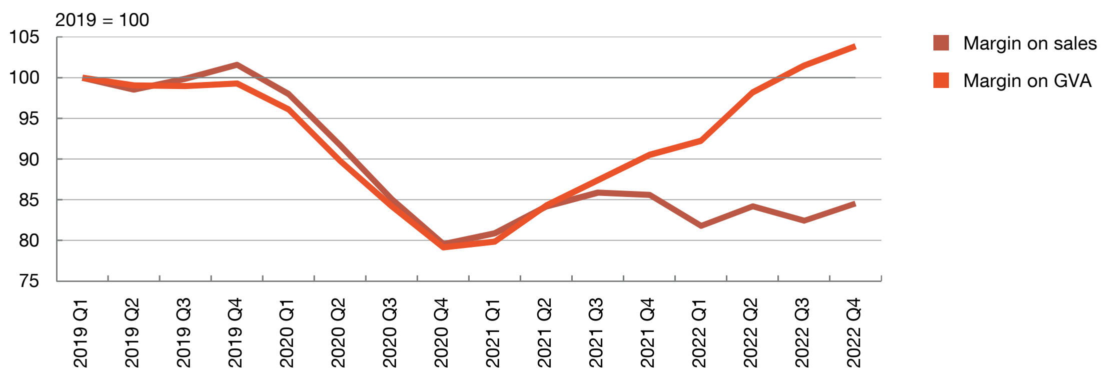
— In any event, as in previous quarters, these aggregate developments mask substantial heterogeneity across sectors and firms.[13]

Chart 23

23.a Changes in profit margins (GOS/GVA) according to National Accounts data. Breakdown by sector



23.b Changes in profit margins according to CBQ data (a)



SOURCES: Banco de España and INE.

a Margin on sales is defined as the ratio of GOP to net turnover. Margin on GVA is defined as the ratio of GOP to GVA. Four-quarter cumulative data.

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13 See, for instance, "Quarterly report on the Spanish economy", *Economic Bulletin - Banco de España,* 4/2022, and "Box 1. Recent developments in firms' profit margins drawing on Central Balance Sheet Data Office data". In "Economic and financial performance of Spanish firms in 2021 and in the first three quarters of 2022 according to the Central Balance Sheet Data Office", *Economic Bulletin - Banco de España,* 4/2022.

24 The Banco de España's latest macroeconomic projections revise GDP growth slightly upwards for 2023

— The last section of this report describes the key features of the Banco de España's latest macroeconomic projections over the horizon 2023-2025. These projections were completed in early March, prior to the emergence of the recent tensions in the international financial markets.

— Under the assumptions of the exercise, Spanish GDP is projected to grow by 1.6%, 2.3%, and 2.1% in 2023, 2024 and 2025, respectively.

— Compared with the projections published in December, the current projections revise GDP growth for 2023 up by 0.3 pp, essentially as a result of greater growth than expected in 2022, which entails a positive carry-over effect on the annual average growth rate in 2023. In addition, the assumptions relating to external markets and fiscal variables are now somewhat more favourable for growth in 2023, offsetting the negative impact associated with the upward revision to the future path of interest rates over the projection horizon. Conversely, the growth projected for 2024 has been revised downwards by 0.4 pp to 2.3%, while that for 2025 remains unchanged.

— Compared with the previous projections, the average inflation rate for 2023 is revised downwards by 1.2 pp to 3.7%. This revision is mainly explained by the energy component, while food prices and the underlying component are revised up. As regards the rest of the projection horizon, headline inflation rates are expected to decline to 3.6% in 2024 and to 1.8% in 2025.

— Against a backdrop of high uncertainty, the risks to the projections are trending downwards in terms of economic activity and are balanced for inflation.

Figure 1

	2023	2024	2025
GDP	1.6% ⬆ 0.3 pp	2.3% ⬇ 0.4 pp	2.1% 0.0 pp
Inflation	3.7% ⬇ 1.2 pp	3.6% 0.0 pp	1.8% 0.0 pp

SOURCE: Banco de España.