Editorial[1]

In recent months, financing costs for households and firms have continued to increase across the different types of borrowing and instruments. These developments reflect the change in the European Central Bank's (ECB) monetary policy stance, which commenced at the end of 2021 and has, to date, entailed an increase of 400 basis points (bp) in the key ECB interest rates. This increase has immediately been transmitted to market reference interest rates. Meanwhile, the pass-through to the cost of new loans to households for house purchase is taking place more slowly than would be expected on the basis of historical regularities, whereas in the case of new loans to firms it is taking place at a similar pace to the past.

In parallel, the supply of bank credit appears to be tightening. This is indicated by the latest available surveys of lenders (banks) and borrowers (firms and households). According to banks, the contraction of the supply of credit is essentially explained by the increase in perceived risks associated with the deterioration in the macroeconomic outlook and by banks' lower risk tolerance. The greater difficulty in accessing credit appears to have affected, in particular, lower income households, smaller and younger firms and firms with greater financial vulnerabilities (see Box 1).

The lower demand for funds due to higher interest rates, along with the reduction in the supply of funds, has led to a significant fall in new financing raised by households and firms. These developments have been apparent since last summer. In the case of households, the decline has been more marked in the segment of loans for house purchase, while in that of firms, the contraction is more pronounced for larger loans and issues of fixed-income securities, transactions generally conducted by larger companies. The decline in new financing flows has also entailed a fall in the debt of these sectors. In the case of households, this has been intensified by an increase in repayments on outstanding mortgages, in particular variable-rate ones, whose cost has increased significantly in recent months.

The financial situation of households has improved, with a gradual recovery of the purchasing power they had lost since 2021 because of high inflation, although the adverse effect of higher interest rates on the disposable income of debtors has intensified. The recent recovery in purchasing power was essentially underpinned by the improvement in employment, the increase in nominal wages and lower consumer price inflation. Meanwhile, the average cost of outstanding debt rose by 65% between December 2021 and April 2023, with the impact concentrated among households with variable-rate loans, which represent around one third of all households. According to microdata-based simulations, lower income households are in a relatively worse position to deal with higher inflation and, in the case of indebted ones, greater debt servicing costs (see Box 2).

1 The cut-off date for this report is 30 June 2023.

The downward trend in the household saving rate from the all-time highs it reached during the pandemic has come to an end. The recent rise in the saving rate appears to have been driven by the improvement in households' purchasing power and the contraction in consumption. In any case, the behaviour of the savings rate in recent years has been consistent with the accumulation of liquid assets by households. Since late 2022, against a background of rising interest rates, there has been a shift in these assets from cash and sight deposits to instruments with a higher expected return, such as Treasury bills, time deposits and investment funds.

Overall, households have strengthened their financial position since late 2022, although the most vulnerable segments appear to have seen a greater deterioration in their ability to repay debt and meet other expenses. Thus, 2022 Q4 data show an increase in gross wealth, in real terms, following the falls seen in previous quarters, thanks to inflation easing. Moreover, the household debt-to-disposable income ratio declined notably in 2022 on account of the buoyancy of nominal income and, also, although to a lesser extent, the reduction in outstanding debt. Thus, at the end of last year, this indicator stood at its lowest level since 2003. Notwithstanding this, households with variable-rate debts, and especially those with lower incomes, appear to have experienced greater difficulty servicing their debt and meeting other expenses.

In this setting, some signs are discernible of a deterioration in the credit quality of loans granted to households. Although non-performing loans continued to fall sharply, a rise has been observed since the end of 2022 in loans classified by banks as Stage 2 loans.[2] This increase affected loans for house purchase and, to a greater extent, consumer loans. By contrast, in the case of lending to sole proprietors, the falls in non-performing and Stage 2 loans continued.

The financial situation of firms has continued to improve, overall, although with some variability across sectors. According to the Central Balance Sheet Data Office Quarterly Survey, ordinary profit increased in 2023 Q1, driven by the growth in economic activity and, in some cases, by the recovery in margins on sales. As a result, firms' profitability stood above pre-pandemic levels in most sectors, although higher debt service costs appear to be curtailing profit growth already. In any event, it should be borne in mind that these results are based on a small sample of generally large firms. The qualitative information from surveys of firms shows that smaller companies' profits performed worse.

Firms' liquidity buffers have not changed significantly in recent months and stand above their 2019 levels. This conclusion is derived from firms' balance sheets and also from credit facility data available in the Banco de España's Central Credit Registry. Liquidity buffers built up through credit facilities are more important for larger firms than for smaller ones.

As in the case of households, debt-to-income ratios have also declined for firms in recent quarters, although the proportion of profits used for debt servicing has risen. The fall in the

2 Loans are classified as non-performing either when they are in default, i.e. there are amounts more than 90 days past due, or else when there are indications that the loan is unlikely to be paid (e.g. the equity of a firm is negative). Loans are classified as Stage 2 when their credit risk has increased significantly since initial recognition, without fulfilling the requirements for classification as non-performing. Generally, they include those with amounts more than 30 days past due.

debt ratio was driven by the improvement in profits and also by a decline in borrowed funds. Meanwhile, the rise in the debt burden, which has been moderate, although very widespread across sectors, is explained by the increase in the average cost of debt, as a result of the gradual pass-through of higher interest rates to the cost of liabilities.

Against this background, the proportion of financially vulnerable firms appears to have continued to decline and no signs are discernible of a significant deterioration in firms' credit quality. Thus, firms' non-performing and Stage 2 loans have continued to decline in recent months. The sharpest decreases were in the sectors hardest hit by the pandemic, whose ability to pay has improved significantly since 2022, as economic activity has returned to normal following the lifting of the restrictions on movement. No deterioration in corporate bond credit ratings nor any rise in the number of corporate insolvencies has been observed.