EDITORIAL

Editorial

Global economic activity has slowed in recent months. In Q2, the deceleration was particularly pronounced in China, against a background of notable weakness in the real estate sector. Other economies were, by contrast, more buoyant. In particular, the United States stood out, with strong domestic demand underpinned by its robust labour market. As regards Q3, the available evidence suggests a further slowdown in world activity, with divergence, once again, across geographical areas. At sector level, manufacturing continues to show considerable slack, especially in comparison with services. That said, the buoyancy of the latter sector has tended to moderate over the summer months.

The euro area economy remains somewhat subdued. Euro area GDP stagnated in the final quarter of 2022 and grew by only 0.1% in each of the first three quarters of 2023. The PMI indicators available to August suggest that activity has become even weaker during the summer. As at global level, developments in manufacturing, against a background of weakening demand outside the euro area and tightening financial conditions, have been particularly unfavourable. Moreover, the outlook is not encouraging either, in view of the poor behaviour of orders. Services have also shown signs of slackening over the summer, probably reflecting the spillover of the sluggishness in the industrial sectors and also, possibly, the fading of the stimulus provided by pent-up demand following the pandemic.

In spite of the weakness of GDP growth, job creation in the euro area has been relatively strong. Indeed, compared with 0.2% GDP growth in cumulative terms between 2022 Q4 and 2023 Q2, employment increased by almost 1%. Possible reasons for this apparent discrepancy (also observed in other economies) include the fact that the composition of recent economic growth has been skewed towards services, which are more labour-intensive than industry, and a certain amount of labour hoarding by firms. The latter reflects labour market tightness, evident in the low unemployment rates and high level of unfilled vacancies, which leads to firms retaining workers in the face of modest downturns in activity that are assumed to be temporary.

During the summer, headline inflation in the euro area has remained relatively stable, although this aggregate stability masks diverging trends in its main components. In recent months, the slowdown in food and non-energy industrial goods prices that started at the beginning of the year has continued. In August, services inflation edged down slightly following the rises in previous months. Even so, the growth rate of this component of consumer prices remains very high. These developments have taken place in the context of notably buoyant demand for recreation and hospitality services and hardly any signs of moderation in wage costs, which account for a large part of overheads in these sectors. Lastly, driven by the rise in oil prices resulting from supply cuts implemented by some of the main producing countries, energy inflation surprised on the upside in August.

Economic activity in Spain has also shown signs of weakness over the summer. Having grown by 0.4% in Q2, the latest information available suggests that GDP has grown by around 0.3% in the current quarter. In particular, this conclusion is supported by the PMI indicators, given the steepening of the downtrend that started in the spring, and by the results of the latest Banco de España Business Activity Survey, which indicate a weakening of firms' turnover in Q3.[1] Social security registrations remained on a steady path in Q3. That said, average month-on-month employment growth between May and August was clearly lower than during the first four months of the year.

In any case, GDP growth in Spain has been stronger than in other euro area countries. This is explained, above all, by the differences in the sectoral composition of the Spanish economy. Indeed, the recent strength of activity in Spain appears to be partly related to the greater importance of its hospitality and tourism-related services sectors, which have continued to experience very high demand over the summer. Manufacturing (currently also less buoyant in Spain than services), meanwhile, is comparatively less important in the Spanish economy. Furthermore, the most energy-intensive manufacturing sectors, which have shown the most weakness in recent quarters, have behaved relatively more favourably in Spain than in the euro area as a whole or, for example, in Germany. In addition, the proportion of Spain's exports that goes to China, an economy that has been slowing rapidly, is smaller than in the case of the euro area as a whole.

Headline inflation has picked up somewhat in Spain during the summer months. As food and non-energy industrial goods prices continued to fall, the rise in headline inflation in July and August, compared with the spring months, has mainly reflected the recent increase in heating and vehicle fuel prices and various base effects associated with energy price dynamics in 2022 Q3. In any event, the downward trend in underlying inflation is still moderate.

The latest information suggests activity will remain relatively weak in Q4. This appears to be the result, among other factors, of the persistence of the sluggish external environment and the continuation of the pass-through of monetary policy tightening to the cost of new loans and indebted agents' debt burden.

From the beginning of 2024 activity is expected to regain momentum. This would stem from the recovery in the external environment, the improvement in households' real incomes (as inflation declines over the course of the year) and the expected faster roll-out of the investment projects under the European NextGenerationEU (NGEU) programme. However, the economy's increased dynamism would be weighed down to a certain extent by the completion of the pass-through of monetary tightening to financing conditions, the gradual withdrawal of the support measures rolled out by the authorities in the context of the energy crisis and more muted growth in tourism activity once pre-pandemic levels are regained. Overall, after growing by 2.3% this year, the latest macroeconomic projections of the Banco de España, presented in this Quarterly Report, foresee GDP growth of 1.8% in 2024 and 2% in 2025.

1 Fernández Cerezo, Alejandro and Mario Izquierdo. (2023). "Encuesta a las empresas españolas sobre la evolución de su actividad: tercer trimestre de 2023". *Economic Bulletin - Banco de España,* 2023/Q3. https://doi.org/10.53479/33733

In the short term, the path of the headline HICP in Spain will be shaped mainly by the energy component. The recent rise in oil prices, the upward base effect of the fall in heating and vehicle fuel prices in the final stretch of 2022 and the expiry in 2024 of the government measures implemented to mitigate the consequences of the energy crisis will lead to a pick-up in headline inflation until the middle of next year. However, non-energy inflation is expected to gradually decelerate. The projected disinflation would mainly stem from the completion of the pass-through to consumer prices of past increases in intermediate input costs and monetary policy measures, assuming, in line with developments to date, that current inflationary pressures will not have significant second-round effects that could trigger feedback loops. In annual average terms, HICP inflation is expected to increase from 3.6% in 2023 to 4.3% in 2024, and to decline to 1.8% in 2025.

The risks to the baseline scenario presented in this Quarterly Report are tilted to the downside with regard to activity and balanced with regard to inflation. A very important source of uncertainty is the difficulty in calibrating the scale of the effect on activity and prices of the monetary policy tightening to date, which could lead to scenarios of further weakness in activity and prices or, conversely, to the current high inflationary pressures becoming entrenched. Moreover, global economic developments could unfold more unfavourably than envisaged in the baseline scenario, possibly due to a sharper than expected deceleration of the Chinese economy. In addition, there are multiple areas of instability in the global geopolitical environment that could lead to a scenario of higher inflation and a worse outlook for economic activity if they were to flare up.