Letter from the Editors

The international context has deteriorated sharply since the July issue of *Spanish and International Economic & Financial Outlook (SEFO)*. According to leading indicators, the risk of recession has increased in three of the world´s leading economic growth engines, – the US, China and the eurozone. For the first time since the start of the post-COVID recovery period, the global purchasing managers' index (global PMI) fell below 50 in August, marking the threshold for a contraction.

This deterioration is largely a reflection of the intensification of the energy crisis, particularly in gas markets. The stagflationary nature of the energy disruption has prompted the ECB to cut its eurozone growth forecasts and sharply raise those for inflation.

Within this uncertain context, the September issue of *SEFO* starts off by assessing the outlook for the housing market, one of the main unknowns in the current economic environment, with critical potential ramifications for both social and financial stability.

Despite the drop in household income as a result of prevailing inflation, the housing market has remained dynamic: transaction volumes are up 20% so far this year and prices are tracking 8% higher. This atypical trend is attributable to the safe-haven appeal of housing at a time of rampant inflation, in addition to the savings accumulated during the pandemic and access to abundant financing. The current bull market may be reaching an inflection point, however, in light of the tighter monetary policy stance. Though we still expect prices to increase by around 6% on average this year, in line with our earlier estimate, a marked slowdown is predicted for next year. The market will not collapse, however, in light of the strong underlying demand and relatively healthy financial position of households. The main risk to that baseline scenario is not the formation of a bubble (as is the case in other countries), but rather the macroeconomic fallout from the energy crisis and general climate of uncertainty.

We then take a deeper look at how gas market tensions are expected to impact Spain. The "Save Gas for a Safe Winter" plan approved by the European Commission involves a 15% reduction in gas demand between August 1st, 2022, and March 31st, 2023, although some countries, such as Spain, will only face a reduction of 7%. On the productive side, the economic sector most sensitive to a rationing of gas consumption will be industry and, in particular: (i) chemicals and pharmaceuticals; and, (ii) the transport and storage sector, which have the greatest direct weight in Spain's GVA (also in the euro area). From a country perspective, among the large European nations, Germany and Italy are most exposed to this geopolitical risk, while

Spain is less sensitive, not only because its industry consumes very little Russian gas, but also because the country´s expected reduction in demand will be lower. In any case, Spain will still be exposed to the risks that this adverse geopolitical environment poses for the coming autumn-winter.

The next three articles in the September *SEFO* examine how the recent shift in ECB monetary policy, namely, the beginning of the interest rate hike cycle, will impact both the financial sector, as well as firms.

As regards the banks, they now have the opportunity to advance on the challenge of boosting their profitability. With interest rates gradually rising, the banks are looking at business and margin growth prospects not enjoyed in recent years. However, the new rate climate is not all good news for the banks, particularly in the current complex economic environment, characterized by high uncertainty (largely as a result of inflation and deteriorating confidence), which does not bode well for immediate growth in business lending volumes sufficient to translate into significant growth in profitability in the near-term. Indeed, latest available figures show that prior to ECB rate hikes, Spanish banks´ net interest margins remained stuck at 0.8% of average total assets, with interest income at around 1.1% and interest expense at 0.3%. That said, Spanish banks remain at the forefront of increasing operating efficiency through reducing operating expenses and fee and commission income has been growing, albeit displaying a high degree of volatility. Moreover, a number of risks carried over from the previous financial crisis remain, including those related to: business sector vulnerability; the ability to repay the state-guaranteed loans extended during the pandemic; and, the looming end of the various credit relief schemes.

As well, the timing of asset and liability repricing will play a key role in the pace of profitability increases. The historical evidence-backed convention indicates that the banks' net interest margin gets squeezed far more during times of low rates and, certainly during periods of zero or negative rates, as has been the case in the eurozone for more than five years. By this logic, the Spanish and European banks' margins should improve within the context of the new, positive interest rate environment. The most important curve for the retail banking business is 12-month EURIBOR, which is currently trading firmly in positive territory, after more than five years in negative terrain. However, rate increases will not translate into higher net interest income (NII) in a linear fashion. In fact, it is highly probable that we will see the banks' income etch out a sort of J-curve, with margins actually dipping before recovering and heading decisively north. The reason for this is the different pace and intensity of bank asset and liability repricing in response to the new EURIBOR curve. Indeed, the pace of repricing is slower in the case of floating mortgages (an asset category of significance for the Spanish banking system), giving rise to the initial effect of contracting margins prior to a gradual recovery ahead of moving into clear positive territory.

As regards corporates, the recent reversal of the ECB´s unconventional monetary policy is already driving interest rates higher, raising the risk of triggering an increase in corporate bankruptcies, which would increase the private sector´s marginal cost of borrowing even further. In this regard, this issue of *SEFO* analyses the measures implemented since the financial crisis of 2008 and the extent to which they have affected the real economy, with a focus on how they have affected business loan price formation. Our analysis shows that both the ECB´s corporate bond buyback program and its liquidity scheme have played a particularly important role in reducing the cost of borrowing for SMEs since 2014. The reversal of those unconventional monetary policies will drive interest rates higher, as we are already seeing. That phenomenon could trigger an increase in corporate bankruptcies, which would increase the business community's marginal cost of borrowing even further. The thorny issue for the central banks is whether the

existence of inflation *per se* has more adverse consequences for the economy than the path of rate tightening they establish. This will be the crux of the difficult debate for governing councils´ of central banks globally going forward, particularly since monetary policy has already begun shifting direction all around the world, as exemplified by the ECB's recent moves to hike its key rates by 50 basis points and subsequently by 75 basis points and provide new forward guidance.

We close the September *SEFO* by analysing the impact of recent fiscal measures taken to mitigate the consequences of the pandemic as part of the broader outlook for future fiscal stability, as well as inequality in Spain.

As regards fiscal consolidation, decisive policy actions in response to the pandemic at the EU and Spanish level have been more effective than those taken to tackle the Great Recession. However, those same decisions have also clouded the outlook for fiscal stability. Transitory relief is drawing to an end at a time when interest rates are increasing, and the adverse effects of uncertainty will weigh on GDP growth and its trajectory back to pre-pandemic levels. In the first half of the year, the overall deficit has come down sharply to already below the target of 5% for 2022, compared to 6.8% in 2021, although the forecasts for this year are not entirely aligned. The positive and unexpected dynamics of tax collection are the reason why the increase in public spending is not having a significantly adverse impact on the deficit. Assuming no change in policy, the government expects the deficit to gradually trend down towards around 3% in 2025, shaped by a structural deficit which, despite a slight improvement, would remain above 3%. Moreover, while the government is forecasting a very slow but steady reduction in the debt ratio, the Bank of Spain sees no prospect for improvement. Within this context, it is not enough to hope for correction via the economic situation, which looks likely to be more complex in 2023 than was anticipated a few months ago. To ensure compliance with the incoming European fiscal rules and the eligibility criteria for the new Transmission Protection Instrument, limit the country's debt service burden in the medium-term and win back space for discretionary fiscal policy, now is the time to define reforms and targets to realign public revenue with expenditure.

On the topic of inequality, were it not for the mitigating social protection measures rolled out, the effects of COVID-19 on Spanish households' primary income would have been felt more keenly in the lower income brackets and would have translated into a sharp increase in inequality. Public transfers offset a significant portion of the income lost by the households most affected by unemployment or disability. However, they were not capable of fully neutralising the increase in inequality. The adverse effect on disposable income was concentrated in the first decile of the income distribution. Moreover, the persistence of pockets of poverty in Spain cannot be blamed on the crisis induced by the pandemic but rather must be attributed to more structural factors related with low levels of education and job qualifications in some segments of the population, the insufficiency of the minimum income scheme, the scarcity of help for families and the limited size of non-contributory pensions.