# Letter from the Editors

The IMF's spring round of forecasts paints an uncertain picture for the next two years due to inflation, geopolitical tensions and their impact on international trade, and financial turbulence following the crisis in the regional banking sector in the US and the collapse of Credit Suisse in Europe. The Fund's experts forecast global growth of 2.8% in 2023, 0.6pp less than in 2022, and 3% for 2024. The slowdown would be particularly pronounced in the case of the eurozone, but the US economy would also show significant weakening, especially in the second half of the current fiscal year, due to tightening monetary policies.

The weaker growth outlook for Europe is in line with the European Commission's forecasts, although Brussels also points to favourable factors, including lower energy prices, the solid performance of the labour market and the strong recovery in tourism. As a result of this turnaround, the Commission has revised upwards its growth forecast for the eurozone to 1.1% in 2023 and to 1.6% in 2024.

Given the importance of the evolution of prices to the outlook for monetary policy and hence, the overall macro picture, in the May issue of *Spanish and International Economic & Financial Outlook (SEFO),* we focus on the recent performance of inflation in Spain, together with a more detailed analysis of just how exactly price increases are affecting different segments of the population.

Despite the volatility of the energy and food markets, as well as their vulnerability to global geopolitical tensions, these exogenous factors fuelling inflation in Spain since mid-2021 have started to wane. Assuming no major surprises on the geopolitical front, both energy and food prices will exert downward pressure on the CPI. That said, the disinflation process will be gradual, as core inflation –which remains elevated – is now determined by forces which are independent of the origin of the initial shock. Until recently, core inflation has been driven mainly by the dynamics of corporate profits. But we are now seeing some recovery in wages, thereby making for a slow disinflation outlook. Altogether, except in the unexpected advent of a recession or sharp correction in imported prices, it is unlikely that core inflation will return to its 2% target before the end of 2024. This, along with perceived risks of inflation expectations decoupling, makes it unlikely that we will see a return of expansionary monetary policy any time soon.

In the wake of the crisis generated by the pandemic, worry over inflation is once again dominating the economic debate. On the social front, the intensity and persistence of this bout of inflation is causing a raft of undesired collateral effects for households: sharp erosion of real income; higher costs for staple products; higher mortgage servicing costs and difficulties in setting aside savings. All these problems have intensified in the

last two years, with the consumer price index (CPI) jumping from 3.1% in 2021 to 8.4% in 2022. However, the headline figures mask far bigger price increases in a broad spectrum of basic goods and services. For example, electricity costs surged 35.6% higher in 2021, while olive oil prices shot up by 26.1% in 2022. Using the micro-level basket of goods and services included in the Spanish Household Budget Survey (SHBS), this paper calculates a price index by household for 2021 and 2022. On average, the results clearly show that the post-pandemic inflationary phenomenon has hurt less well-off households proportionately more, particularly those in the first three income deciles. In other words, the households that spend roughly 14,000 euros per annum (around 1,200 euros per month). The regions most affected have been Castile-La Mancha, Castile-León, Extremadura, Galicia, La Rioja and Aragón, which between them represent the bulk of unpopulated or so-called 'empty Spain'. The households located in the smallest towns, with fewer than 10,000 inhabitants, have been affected the most, particularly those over 65 living alone.

We then turn our attention to the financial sector, to assess how monetary policy tightening in response to the recent bout of inflation has, albeit part of a process of rate normalisation, generated some challenges as regards financial stability in the traditional banking sector, but also within the ever-increasingly risky shadow banking sector.

The episodes of financial instability observed in the US and in Europe at Credit Suisse in March and the ensuing international contagion have given pause for thought about the implications of financial normalisation via monetary tightening underway. Although the European banking sector, including the Spanish banks, is proving generally more resilient, the bouts of instability had a pronounced adverse impact on most financial intermediaries. As for the Spanish banks, they continue to bolster their solvency while keeping non-performance low. Although it is hard to draw comparisons and the market environment is very volatile, an analysis of the 12-month returns in the various banking sectors one month on from the fall of SVB and Credit Suisse shows the Spanish banking sector outperforming the European and US averages. The chief challenge is for the US supervisor to convince the markets that it can reform its supervisory mandate quickly enough to prevent similar situations from occurring among its mid-size banks. Meanwhile, most international analysts and institutions are flagging non-bank financial intermediaries, and the shadow banking ecosystem in general, as potential sources of instability worth monitoring.

Subsequently, we explore how the banks are managing their balance sheets in the context of monetary policy changes, specifically looking at the issue of deposit beta, and how simply passing on rising interest rates to depositors may not be as straightforward an exercise as it initially seems.

More than one year after 12-month Euribor abandoned negative terrain, after rallying to levels not seen since before the financial crisis, the big dilemma facing the banks is at what pace and to what extent they should pass the increase in market rates on to their customers, embodied by the so-called 'beta' coefficient, by analogy with that used in the equity markets to measure share price sensitivity to the market index. So far, the percentage of the buildup in Euribor that gets passed through to deposit rates, or deposit beta, in Spain is proving smaller than that being observed on the asset (lending) side of the business and in other European countries, drawing sharp attention from the media. Compared to past episodes of rate tightening in Spain, we are seeing a weaker/slower pass-through beta this time around, in particular in the case of term deposits. However, the loan pass-through beta is also lower by comparison with other periods on account of the intensity of the upward shift in the curve, the effect of rate repricing on the banks' portfolios and the relatively higher weight of fixed-rate loans at present. In any event, any analysis of the current situation requires taking stock of the banks' holistic pricing strategy as a function of their combined positioning in assets and liabilities, the

make-up of their customer bases on both sides of the business and their transformation and capital cost structures. Nevertheless, sooner or later, competitive pressure is bound to drive an increase in the deposit beta.

Next, we shift gears to assess the current status and challenges related to Spain's execution of Next Generation EU funding. The Strategic Projects for Economic Recovery and Transformation (PERTEs) were created to channel the Next Generation EU (NGEU) funds into areas identified as priorities for the modernisation and competitiveness of the national economy. The idea is to channel over 40 billion euros of public investment into a dozen strategic areas. That is around one-quarter of all the funds Spain stands to receive under the Recovery and Resilience Facility. Despite having been created to allocate funds into areas of strategic importance for Spain's economic advancement, PERTE execution has stumbled upon certain difficulties. By year end 2022, only around 5.6 billion euros had been committed (tenders and grants adjudicated), which is less than half of the funds channelled using this instrument. The key challenges to have emerged since approval of the first PERTE in July 2021 can be classified into three major categories: (i) challenges associated with requirements specific to the grant calls; (ii) challenges linked to the regulatory environment; and, (iii) challenges derived from economic and market conditions. Going forward, in addition to ex-ante assessments performed prior to the publication of calls for PERTE grants, it will be important to monitor and evaluate the initiatives after adjudication to ensure European funds are channelled effectively and maximize their reach. [1]

We close this issue of *SEFO* by looking at Spanish household and corporate accounts. First, we assess the performance of Spanish households and corporates in the last few years to understand how each sector is recovering post pandemic. Finally, we look at the outlook for household and corporate financing conditions in Spain within a European context.

The pandemic has had a relatively limited impact on the aggregate level of household finances in Spain with the sector's GDI recovering to 2019 levels by 2021. The household sector also set aside a significant savings buffer, which following official statistics revisions, turned out to be even higher than initially estimated at 137 billion *versus* 94 billion euros. In the case of the corporate sector, revised figures show that the negative impact of the pandemic on corporate income was actually stronger than originally anticipated. Indeed, between 2020 and 2021, the non-financial corporations generated a net lending position of 12.2 billion euros, instead of the initially reported surplus of close to 78 billion euros. As a result, the original conclusion drawn that the household sector's accounts had held up remarkably well in 2020-2021, in contrast to the impairment sustained by the business sector, not only remains valid, but rather the contrast between the two sectors' performances is starker than originally thought. In 2022, however, the corporate sector's finances fared better than those of the household sector, fully recovering from the hit taken in 2020. Nevertheless, corporate profits (after tax) have increased by less compared to pre-pandemic levels than household income (+1.4% *vs.* +4.7%), partly due to lower growth in their pre-tax income and partly due to the relatively bigger increase in the effective tax rate sustained by the corporate sector- a major topic of debate at present.

Access to bank loans has become tougher in recent months primarily as a result of the increase in interest rates. Borrowing rates have risen due to a combination of factors: central bank rate hikes; perceptions of increase in risk; an increase in the banks' aversion to lend; the prospect of an economic slowdown; and the recent bout of financial instability. That said, since January 2021, when 12-month Euribor hit a record low, Spanish banks' lending rates have increased by less than in the eurozone on the whole. Specifically, however, while corporate lending rates in Spain are lower than the eurozone average, mortgage and consumer lending rates are higher. The rate of growth in new lending activity has slowed, with

business lending outpacing household lending by a wide margin. The growth in interest rates is leaving businesses and households poorer. Considering that in 2022, businesses earmarked 6.9% of their gross disposable income to the payment of 14.36 billion euros of interest, with households spending 0.8% (6.44 billion euros), an increase of 2 percentage points in borrowing costs in 2023 would increase the two segments' interest burden by a combined 33 billion euros. The good news is that both the business and household segments are better positioned to tackle the increase in borrowing costs than in the past thanks to significant deleveraging: the ratio of private debt-to-GDP decreased by 23pp between 2020 and 2022.

## Notes

[1] Given the recent results of the regional and local elections in Spain, which took place just prior to the publication of this issue of *SEFO*, NGEU fund execution may be subject to changes.