Letter from the Editors

Recent trends point to a weakening of the international environment, especially in Europe. In June, the PMI for the eurozone fell to just below 50, pointing to a contraction in activity. The trend is also towards a slowdown in the US and China, albeit less pronounced than in Europe, with PMI indicators still in expansionary territory.

In its latest outlook, the OECD predicts global growth of less than 3% in both 2023 and 2024, a significant decline compared to 2022 which would be mainly due to the tightening of monetary policy. The economic weakening would mostly affect the eurozone.

Within this context, in this July issue of *Spanish and International Economic & Financial Outlook (SEFO),* we start off by looking at financial turbulence at the global level, subsequently supplementing this analysis with perspectives for the Spanish economy.

Financial turbulence has been easing in recent weeks, reflecting the idiosyncratic nature of the Silicon Valley Bank (SVB) and Credit Suisse (CS) failures and the adequacy of the responses by the affected central banks, although some risks remain. Monetary tightening led to a more than 4pp increase in official rates worldwide in 18 months, a movement with no precedent in recent decades in terms of its speed or intensity. Such pronounced and intense rate increases constitute a steep stress test for banks with solvency and/or liquidity weaknesses. The good news is that the fallout has been fairly limited. The US authorities have managed to: protect deposit holders; minimise risks for taxpayers; and, curtail the loss of confidence in the regional banks which in many states are key for monetary policy transmission. Questions remain as to where the next hotspots of instability could lie, with potential high-risk areas including: commercial real estate valuations; hedge fund leverage; loans by US banks to non-bank financial institutions; liquidity at certain life insurers in the US; and, structural weaknesses in some mutual fund categories. Thus, we need to be aware of the difficulties that will face the central banks as they near the end of their monetary policy tightening process, as the complexity of restoring price stability while minimising outbreaks of financial stress is set to increase.

As regards the Spanish economy, the energy crisis and war in Ukraine marked the start of a period of uncertainty. However, the main macroeconomic variables have performed better than most analysts were expecting. This resilience may be attributable to the competitiveness of Spanish exporters, the absence of a property bubble (in contrast to the situation prevailing in many other European economies) and low household indebtedness. In the months ahead, the Spanish economy will be shaped by the disinflation process and monetary policy developments. Overall, despite anticipated cooling, the strong start to the year is expected to leave GDP growth at 2.2% in 2023, up 0.7 points from our last set of forecasts. In 2024, growth is expected to slow to 1.6%, albeit improving as the year unfolds. There are also downside risks, however, especially surrounding the risk of sharper than anticipated monetary tightening. A more pronounced increase in borrowing costs than we are estimating would exacerbate risks in the more vulnerable sectors. Elsewhere, the ECB has warned of vulnerabilities in the finances of the shadow banking system with potential consequences for the European economy. Lastly, the persistence of a high public deficit is a source of vulnerability for the Spanish economy with the European fiscal rules about to come back into play and the ECB withdrawing support in the form of low rates and debt repurchases, a worry with Spain due to step up public debt issuance this year.

We then move on to see how the rapid rise in interest rates, apart from its impact on the global financial system and the economy, has had important implications in terms of financial stability given banks' sensitivity to interest rate changes.

Although the new interest rate scenario is clearly good news for the banks' margins, the intensity, speed and persistence with which the increases have affected all tenors of the curve have other potentially very adverse effects for the banks more exposed to interest rate risk, as evidenced in the recent crises affecting several American banks and, here in Europe, Credit Suisse. In order to prevent contagion with implications for financial stability, it is vital to correctly measure latent interest rate and liquidity risk on both the asset (looking beyond conventional portfolio classification for accounting purposes) and liability sides of the banking business in terms of financial stability and sensitivity. It is against that backdrop that we raise and address two questions. The first relates to the sufficiency of the current regulatory and supervisory framework governing these two principal risks, having failed to prevent or sufficiently foresee the excessive build-up of both risks at the banks in question. The second has to do with risks to financial stability, to which end we analyse the European and US banking sectors to conclude that while EU banks on the whole appear to be less exposed to interest rate and liquidity risk, these aggregate parameters mask significant dispersion among the various entities on both sides of the Atlantic.

As well, for the banking sector, we explore one of the most significant technological disruptions in decades, the development and launch of generative AI, and its preliminary and potential applications in the financial industry.

Despite having been in development for some time, it seems as if AI's moment has arrived. The European banking sector has widely embraced the new technology. According to the European Banking Authority (EBA), 83.3% of European banks currently use artificial intelligence for a range of purposes. That incidence has been rising consistently since 2018. Indeed, the EBA estimates that by 2025, all European banks will have implemented solutions powered by AI. Artificial intelligence is already being used in a myriad of ways. For now, its use is concentrated in the development of solutions that improve the user experience, facilitate performance of the banks' compliance obligations and enable more efficient management of banking risks. Following the success of ChatGPT, the banks are moving to transform their virtual assistants into intelligent digital assistants capable of providing personalised service in real time to their customers, as well as their employees. Going forward, the banks will have to continue to invest in AI to ensure its usage translates into lasting competitive advantages.

We then focus on the fiscal outlook, looking at Spain's broad fiscal policy and consolidation post crisis, as well as provide a more granular analysis of what is going on at the local government level.

Spain recorded a deficit of 4.8% of GDP in 2022, which was better than initially forecast by the government, but worse than the analyst community was forecasting by the end of the year. However, the curtailment of the cost of the expansionary fiscal package and positive surprises in GDP and employment make the 2023 deficit target look feasible. Moreover, 2023 will end four years of extraordinary budget and fiscal policies, with next year marking the year that the Stability and Growth Pact's fiscal straitjacket will be reinstated, albeit likely in a reformed version. Along these lines, the government is forecasting a gradual reduction to leave the deficit at the permitted threshold of 3% by 2024. As for public debt, starting from a figure of 113.2% of GDP in 2022, indebtedness is expected to decline by 6.4 points to 106.8% by 2026, the end of the projection period. The European Commission's assessment of Spanish fiscal policy calls for stronger consolidation efforts in 2024, with conclusions and recommendations more general for 2025 and beyond. As regards the Commission's new fiscal rules framework, the goal of the latest proposal currently under debate is to keep national deficits under 3% in the medium-term and converge towards the debt ratio established by way of common anchor. Any sound fiscal consolidation strategy for Spain should contemplate that the country's high structural deficit requires gradual but unflagging and urgent correction.

While as regards to fiscal performance and the achievement of financial equilibrium, Spain's local governments on aggregate have been the best performing level of the Spanish administration, a more granular assessment reveals vast differences across municipalities. Over 100 municipalities face structural financial challenges, primarily recording too high a level of public debt for too long a time frame. Restructuring public finances across these heavily indebted municipalities will requires implementing policy measures aimed at restoring fiscal sustainability and a balanced budget. The deferral of debt service payments, the main policy tool formulated by the central government in recent aid mechanisms, has proven ineffective to resolve the current fiscal imbalances at the local level and has even at times exacerbated the problem. To tackle the problem identified, new solutions are needed. The local authorities should be held jointly responsible for the restructuring process by making them take the steps needed to balance their budgets over time in a sustainable manner.

We close this issue with an assessment of the state of play and outstanding challenges for Spanish industrial policy, in particular within the context of the quest to maximize NGEU funds. We provide an overview of the key elements of the current debate surrounding the conception, design, and implementation of industrial policy in the EU and Spain. Firstly, we outline the six fundamental external dependencies, or interdependencies, characterising the EU and its member states, which are concentrated in the areas of: trade, energy, raw materials, digitalisation, finance and labour markets/ immigration. Next, we look at the Inflation Reduction Act (IRA) passed in the US in 2022, which includes certain protectionist provisions, and the key responses being explored by the EU. There seems to be consensus around: the importance of avoiding an escalation in trade tensions, assessing the opportunities the IRA may imply for certain EU sectors and keeping trade negotiations open to limit the impact of the protectionist elements. Thirdly, turning to policy in Spain, we analyse some of the obstacles that have hindered the deployment of plans for the country's strategic sectors devised under the umbrella of the NGEU funds: structural/regional weaknesses of the Spanish economy; obstacles arising from regulation and lack of administrative agility; rigidity in tender terms; and, potential to increase agreement among business associations and local authorities. Tackling these obstacles will be key in order to implement appropriate industrial policy measures to ensure the transformation of the Spanish economy.