Letter from the Editors

The global situation remains uncertain, in line with the persistence of armed conflicts in Eastern Europe and the Middle East, with their repercussions on international trade and the transport of goods through the Red Sea. Nevertheless, the relative stability of the energy markets and the resilience of the labor market, among other factors, have encouraged the prospect of a recovery in Europe. This is evidenced by economic indicators, even in Germany, one of the economies most affected by the geopolitical changes. Signs of sustained growth in the US economy are more tangible, while inflation remains above target, reducing the prospects of interest rate cuts by the Federal Reserve. The Chinese economy, meanwhile, seems to be showing signs of improvement in the second quarter.

Within this context, the May issue of *Spanish and International Economic & Financial Outlook (SEFO)* examines the outlook for global trade and investment flows, and in particular how they are impacting the EU. An analysis of EU trade and foreign direct investment flows reveals a relative decline in the EU's export position in global trade as well as a weakening of foreign direct investment (FDI) inflows, with the EU now a major net exporter of capital to invest in companies located in third countries. Although the EU continues to present a current account surplus, this resilience reflects largely lethargic imports rather than a boom in exports of goods, albeit it is worth noting that Europe has fared better in its trade in services. As with the drop in the market share commanded by European goods exports, the trend in FDI evidences a loss of attractiveness of the EU relative to the US and China. Indeed, a comparison between FDI outflows and inflows reveals Europe as a heavy net exporter of capital, which means a significant share of the savings available in Europe is being used to invest in companies located in other countries. That said, there has been an intensification of trade and investment among member states (intra-EU). The mitigating role played by the single market has had particularly healthy benefits for economies like Spain, where labour and energy costs are relatively low. The advantages of the single market can also be enhanced through measures that boost the investment of excess savings within the bloc. Nevertheless, even in its enhanced form, the single market can only partially mitigate the weakening of the external position of the EU *vis-à-vis* other economic powers. This highlights the importance of a revitalisation strategy which includes the capital markets union and the deployment of a common European investment budget, as a follow on from Next Generation EU funds.

Next, we take a walk through history, looking back over the past 50 years of Spanish financial sector deregulation to assess the evolution of the structure and profitability of Spain's banks from the past to the present. The Spanish banking sector, since its deregulation

50 years ago until today, has been shaped by significant structural transformation as a result of the need to adapt to a changing environment and respond to challenges. Indeed, Spanish banks have demonstrated resilience and the ability to adapt to changes in market conditions, financial regulation, disruptive technology and global economic crises. Firstly, it is essential to acknowledge that the sector deregulation embarked on in the 1970s unleashed a series of changes that have profoundly redefined the Spanish banking landscape. The number of deposit-takers in Spain has decreased significantly, from 262 in 1993 to 109 in 2023, illustrating the scale of sector consolidation in response to economic challenges and opportunities to increase efficiency. There has also been a contraction in sector employment, from 270,085 jobs in 2008 to 158,217 in 2022, and in the number of bank branches, from 45,662 in 2008 to 17,603 in 2023. These figures underscore the banks' shift to a more technology-heavy model less dependent on physical infrastructure, evidencing a transition towards digitalisation and operational efficiency in response to new market demands and competitive pressures in a globalised financial environment. In tandem with these structural changes, the composition of the banks' income and expenses has evolved significantly, encompassing efforts to navigate the ultra-low rate environment in the wake of the financial crisis as well as remarkable efforts to boost cost-to-income efficiency. On top of profitability pressures, the management of risks under the growing regulatory push to increase solvency, on the one hand, and technological challenges, on the other, remain the most important issues facing the Spanish banks in the years to come. On this last point, the banks will need to balance the search for scale against the agility required to adapt to new technology and shifting customer expectations.

Relatedly, given the importance of the interest rate channel to the financial sector, we look at the impacts of monetary policy changes from various angles. On the one hand, how, through bank deposits, policy rates may impact the credit supply. On the other hand, how monetary policy decisions by central banks may reverberate back to affect the central banks' themselves, through implications for their balance sheets.

Bank deposits have been shown to play a role in shaping monetary policy and access to credit. This mechanism could be far more pronounced as interest rates experience large and unexpected hikes, and even stronger after a long period of low interest rates. The reasons are twofold: First, at low rates, many banks aimed to extract the maximum value from their deposits franchise by taking interest rate risk and increasing their duration gap. This would mean that many banks would enter the rate hike period with a large duration gap so deposit withdrawals would render their duration gap more pronounced. Second, higher increases in rates would make the stability of "cheap" deposit funding more uncertain as depositors consider alternative sources of funding. Research shows that in euro area countries, banks experiencing deposit outflows choose to reduce credit rather than increase the interest rate they charge. Crucially, firms entering the tightening cycle mostly connected to lenders with higher duration gaps could be significantly less likely to obtain credit as tightening starts, with the likelihood becoming even lower for banks experiencing deposit outflows. More broadly, this phenomenon relates to concerns about financial stability from central banks' tightening their stance after a long period of ample liquidity and balance sheet expansion.

In the wake of the problems affecting several US banks, one year ago we assessed the issue of interest rate risk in the banking book and the effectiveness of the regulatory environment and applicable accounting rules in the prevention and mitigation of such risk. This type of interest rate risk, particularly the risk implicit in an excessive mismatch between asset and liability maturities and/or repricing, has now hit the central banks hard, with some reporting no profits, or even losses, in 2023. An analysis of the asset and liability structure of the Federal Reserve, the European Central Bank (ECB) and the Bank of Spain reveals that interest rate risks, and hence expected losses, are likely to continue to materialize across all three central banks in the coming years albeit along distinct timeframes and in different magnitudes – with the ECB and Bank of Spain expected to report smaller absolute values than the Fed. That said, it is important to note that, unlike private sector banks, central banks are not obliged to recognize their holdings at fair value (*i.e.* they do not have to recognized unrealized losses) or unwind positions, which means that market implications would be very different. As well, central banks should not be judged for their earnings performance, but rather whether they fulfil their mandates. In any event, there may be other implications related to the need for central banks to assess monetary policy rates from the perspective of how they relate to central bank transfers to the commercial banking system.

The following section of the June *SEFO* explores the evolution of private debt dynamics in Spain, but also through a comparative lens at the international level. Corporate income registered significant growth in 2022, making notable progress towards reaching pre-pandemic levels. However, in 2023, it was household income that was more dynamic. The trend in household income has been relatively favourable throughout the post-pandemic years, despite the increase in inflation. This has been largely attributable to the resilience of the Spanish labour market labour, as well as wage growth. These factors allowed Spain's households to absorb the impact of the increase in interest rates in 2023 with relative ease, as evidenced by the stability in the rate of loan non-performance in this sector. As well, household debt, at 74.2% of GDI, reached its lowest level since 2001. In the corporate sector, however, the increase in rates had a more pronounced impact, although that is not the only reason for its relatively weak earnings performance. Indeed, Gross Operating Surplus (GOS) registered moderate growth, down significantly from 2022 and below the growth in the compensation and benefits received by Spanish households, which, in contrast, accelerated. By comparison with 2019, in nominal terms, the income gap between the non-financial corporate (NFC) and household sectors widened, revealing an incomplete recovery in the corporate segment compared to solid growth in household income. Lastly, investment levels at Spain's corporations remain depressed, with firms preferring to use their profits to repay debt, despite already healthy leverage levels by both historical standards and by comparison with their European peers.

The rate tightening embarked on by the ECB in mid-2022, which was paused in September 2023, has had a negative impact on debt sustainability. In the case of Spain's corporations, the interest burden doubled between 2022 and 2023, surpassing the 40 billion euros mark. The interest burden on household borrowings increased by 66% to over 24 billion euros. Looking at the share of income that has to be earmarked to interest payments, the percentage almost doubled in 2023 in the business sector (from 7% to 13%), increasing by less, and from a much lower base, in the case of the household sector (from 1.8% to 2.6%). Nevertheless, the interest burden is below the EU-27 average in the corporate segment (9% *vs.* 12% as of the third quarter of 2023) and very similar among households (2.4% *vs.* 2.5%). As well, the ultralow rate environment until 2022 coupled with private sector deleveraging drove a drastic reduction in debt service costs (interest costs and principal repayment), which did not increase in 2023, as the spike in interest costs was offset by ongoing deleveraging. In 2023, Spain's corporations earmarked 34.7% of their gross disposable income to debt service, while its households set aside 5.6%. These are low readings relative to international standards.

We close this issue of *SEFO* by further drilling down with a micro perspective on important challenges facing Spain's private sector, ranging from business dynamism, to access to financing, in particular for Spain's SMEs, as well as deconstructing what may be behind underinvestment in capital at Spanish non-financial corporates.

Spain was home to 3,207,580 economically active enterprises as of 1 January 2023, growth of 0.5% from 2022. Over two thirds of the total have been in business for less than 11 years. 57% of these businesses are natural persons and have no employees, while 92% have five or fewer employees. A combined analysis of the business population's age and headcount shows that larger companies tend to have been in business longer. For the three main legal structures: natural persons, public limited companies (PLC) and limited liability companies (LLC)– the sectors with the biggest business populations are wholesale and retail trade, building construction, specialised construction services and real estate services. The 10 sectors of the economy with the largest business populations account for between 60% and 70% of all firms across these three forms of incorporation. In terms of turnover, most sectors, other than the retail sector, reported growth in 2023 and also in the first two months of 2024. As well, the studies on entrepreneurship in Spain point to a very significant gender gap across the business population (80% male and 20% female). Broadly speaking, analysis points to a clear divide between the sectors that are home to a higher number of established firms and the sectors with a higher incidence of startups, with the sole exception of the food industry. Essentially, it could be interesting to take a closer look at the scope for creating value by fostering collaboration between these two spheres: Spain's legacy businesses and the startup ecosystem.

Recent financial markets volatility, derived from the economic crises and the transition underway towards a more resilient, digital and green economy, has brought about significant changes in the supply and demand for credit. These changes have disproportionately affected SMEs and micro enterprises, as they are more vulnerable to structural failures in the credit market, which have been aggravated by the prevailing situation. Specifically, SMEs' financing needs have increased, shaped by the transformation of the productive model, which has translated into growth in demand for bank loans and for other types of financing. However, these needs have come up against greater financing constraints as a result of a range of factors, including the uptick in interest rates to curb inflation, driving growth in the cost of financing and, with it, in the incidences of loan rejections and discouraged borrowers. As a result, the estimated shortfall in SME financing has increased to between 22.5 billion euros (per the SME initiative methodology) and 36.9 billion euros (per the fi-compass methodology) in 2023 – between 1.5% and 2.5% of Spanish GDP in 2023, respectively. These figures indicate that the average funding gap increased by 58% between 2019 and 2023, and by 76% between 2020 and 2023. Within this context, public financial instruments, both at the national and regional level, could serve as a key economic policy tool for lending financial support to the productive sector at a time of heightened uncertainty.

An analysis of the stock of fixed capital of Spain's non-financial corporations from 2011 to 2023 reveals the persistence of a post-pandemic time lag in the recovery of corporate investment. The results point to two contributing factors: (i) the trend in the relative costs of capital and labour, unfavourable for the accumulation of capital since 2021; and (ii) the relationship between the return on and user cost of capital. Relative input prices have favoured more labour-intensive production, while the proximity of returns to costs of capital have provided an incentive to invest only the minimum needed to replenish the capital consumed. A recovery in investment will require a recovery in returns to pre-pandemic levels and a drop in the user cost of capital as inflation eases, rebalancing the relative costs of capital and labour in the process.

We hope you find this publication a valuable tool to support your analysis and we look forward to receiving your feedback.