Letter from the Editors

Clearly, the main event since the September publication of *Spanish and International Economic & Financial Outlook (SEFO)* has been the U.S. presidential election, with Donald Trump's victory leaving significant uncertainty about future U.S. domestic and foreign policy.

The external environment remains unfavourable, particularly in Europe, with the IMF revising downward its forecast GDP growth in the eurozone to 0.8% this year and 1.2% in 2025.The forecast for China has also been cut, so that, among the major powers, growth has been revised upwards only for the U.S. Noteworthy is that the Spanish economy continues to outperform significantly the EU average, with growth expected at 3% this year and 2.1% in 2025, which is 0.5 and 0.3 percentage points up from our last set of forecasts.

Relatedly, the IMF sees an increased risk of fragmentation of world trade, with this trend being particularly detrimental to the most export-dependent economies, with China and Europe in the mix. In an uncertain environment, commodity prices, including oil, have tended to decline, with forecasts also pointing to a slight fall for the next two years.

Within this context, we start off the November *SEFO* with our updated forecasts for the Spanish economy, as well as the outlook for Europe through the lens of industrial production and the ECB's new monetary playbook.

The Spanish economy continues to grow faster than the European average. The current growth cycle is being driven by the favourable external competitiveness position, especially in terms of both tourism and non-tourism services. Another factor is the contribution by immigration to the labour force. Public consumption has also fuelled growth, though this is hardly sustainable in light of fiscal rules. As state previously, the economy is expected to grow by 3% this year and 2.1% in 2025, which is 0.5 and 0.3 percentage points up from our last set of forecasts. Despite the economic momentum, the public deficit will not fall below 3% in 2025, coming in half a point above the official target. To align with the target, the government would have to introduce budget savings in the order of 8 billion euros, an effort that would not jeopardise growth in the short-term and would generate benefits in the medium-term in terms of confidence and room for manoeuvre in the event of future shocks.

The euro area's industrial sector, historically a pillar of economic strength, faces significant challenges in the wake of the COVID-19 pandemic and the Russia-Ukraine conflict. These exogenous shocks have exposed structural weaknesses, causing a divergence in performance between countries and sectors. While Germany, France, and Italy have experienced notable declines in industrial output, Spain and smaller eurozone countries have demonstrated resilience, with positive industrial production figures derived in part from varying degrees of reliance on Russian energy. At the sectoral level, energy intensive goods and intermediate products have faced the steepest declines, underscoring structural vulnerabilities, while non-durable consumer goods showed resilience due to lower sensitivity to business cycles. External trade dynamics are further complicating recovery, with additional trade headwinds from China potentially exacerbating existing tensions. Thus, as the region navigates these obstacles, it will be necessary to complement country-specific policies with EU-wide strategies to support key sectors, such as the automotive industry.

Relatedly, we look at the performance of Spain's high-tech exports. Spain's high-tech product export intensity ranked sixteenth in the EU-27 in 2022, which is a considerable improvement from its position between 2014 and 2018. Despite this recent convergence with the EU, Spain's trade deficit in this product category has widened to €16.8 billion in 2023. The biggest contributor to that deficit was the electronics-telecommunications sector (deficit of 11.1 billion euros), followed by computers-office machinery and scientific instruments. Elsewhere, of the sectors reporting a surplus, the largest was less than €700 million. The best performers in that respect were the armament, non-electrical machinery, aerospace and pharmaceuticals sectors. In the latter sector, export volumes to Belgium between 2021-2023 were very significant, yet atypical. Given the role played by the high-tech manufacturing industry in unlocking sustained competitiveness gains, strategies are needed to further improve Spain's recent achievements in this area and to start to close the technology gap with other countries.

Moving on to monetary policy, in 2024, the European Central Bank (ECB) introduced a "new monetary playbook," emphasizing the transition from a rigid rulebook to a more adaptive and flexible operational framework to address today's complex economic landscape. This new strategy relies on calibrated interest rate adjustments, reduced reliance on extraordinary liquidity measures, and a targeted communication strategy to better manage market expectations and reinforce confidence. Key shifts include lowering the deposit facility rate to 3.25% and adjusting the other main benchmark rates in tandem, as well as narrowing the spread between deposit and refinancing rates to encourage bank participation in short-term refinancing operations. These adjustments reflect the ECB's goal of balancing inflation control with economic growth in a volatile and globalized world, where inflationary pressures, energy stability, and fluctuating market conditions require a dynamic policy response. The next review of the ECB's operational policy is scheduled for 2026. While not without risks, this "new monetary playbook" marks a new era, in which the ECB continually fine-tunes its approach in response to evolving economic conditions, holding fast to its commitment to long-term stability and growth.

Relatedly, on the topic of banking, we take a look at the Bank of Spain's recently announced changes to the countercyclical capital buffer (CCyB) as part of a process of ongoing convergence with the European supervisory standards and at the recommendation of the European Systemic Risk Board (ESRB), the institution tasked with issuing macroprudential supervisory guidelines in the eurozone. Framed by the move to increase the buffer rate from 0% at present to 1% in two stages (the first by year-end 2025 and the second by year-end 2026). The new buffer will feature a much more important modification – the requirement to set the neutral buffer rate at 1%, from where it can be increased, but also the possibility of releasing the buffer when warranted by an episode of crisis. These modifications of the CCyB are just the first step in a higher-level review of capital buffers, framed by dual micro and macroprudential dimensions, designed to reinforce banking system resilience. The changes highlight the need to recalibrate Spain's CCyB, taking into account potential tensions between micro and macro perspectives, to allow for greater adaptability in response to the economic cycle. As well, going forward, stress tests should be a crucial part of the toolkit for linking the two perspectives, particularly when determining and redefining the P2G requirement. Nevertheless, the tests existing weaknesses, such as the static balance sheet assumption or the failure to consider the probability of occurrence of the scenario analysed, should be addressed by reforms in order to deliver both financial stability and economic efficiency.

We then shift our focus to fiscal considerations. Importantly, we examine the recent agreement with Catalonia and potential implications for the region, as well as Spanish public finances more broadly. We then assess the functioning of Spain's Independent Financial Institution, the AIReF, benchmarked against its counterparts within the EU, to determine strengths as well as areas for improvement.

The recent agreement reached between Catalonia's Partit dels Socialistes de Catalunya (PSC) and Esquerra Republicana de Catalunya (ERC) marks a potential shift in Spain's regional financing model, aiming to enhance Catalonia's fiscal autonomy while minimizing interregional redistributive flows. Key proposals include transferring the administration of all taxes collected in Catalonia from the central government to the regional tier and establishing a "Catalan contribution" to offset reduced central taxation power. Financial projections indicate that Catalonia's per capita financing would substantially rise. More broadly, however, the agreement could lead to structural changes in Spain's decentralization framework, reducing central government fiscal capacity and potentially influencing other regions to pursue similar autonomy arrangements. While the agreement faces implementation challenges, including the need to reform basic legislation and address the risks of increased tax competition and fiscal fragmentation, it ultimately underscores the need for comprehensive debate on the future of Spain's interregional equity and fiscal stability.

In response to the Global Financial Crisis, an increasing number of countries worldwide adopted independent fiscal institutions (IFIs) to promote good governance in public finances with a view to preventing repetition of such a crisis. By the mid-2010s, all euro member states were required to create IFIs. In Spain, the Independent Authority for Fiscal Responsibility (AIReF) was established as part of a comprehensive legislation consistent with the EU rules-based fiscal framework. In its first ten years of operation, AIReF has helped support the functioning of the country's fiscal policy, enhancing transparency and economic governance. While there are still several areas where AIReF could be improved, the institution's performance is increasingly in line with international standards of good practice across IFIs.

We close this issue with perspectives on a socioeconomic note – taking a look at the gender wage pay gap in Spain. An analysis of data from the *Wage Structure Surveys* undertaken between 2002 and 2022 reveal that over the last two decades, Spain's gender pay gap has narrowed significantly, from 29% in 2002 to 17%. The meaningful reduction so far this century appears to be partly attributable to higher labour intensity and significant flows of women into higher-paid sectors and occupations over the last decade. However, the most recent data suggest that the pay gap is currently stagnant at 2022 levels, prompting a debate about the policies that need to be adopted, such as those aimed to deliver more equitable childcare and more flexible working hours, to achieve further convergence in the years to come.