Letter from the Editors

The weakening of the global economy that was already present at the time of publication of the previous *Spanish and International Economic & Financial Outlook* (*SEF*O) has been confirmed at the time of writing this November issue. Economic indicators point towards recession at the end of the year – the global purchasing managers´ index (global PMI) is below 50, marking the threshold for a contraction. The European economy is one of the hardest hit by the energy crisis. In its latest projections, the European Commission places the eurozone on the brink of recession, with an anticipated growth of 0.3% in 2023, compared to 2.3% in the July forecast. In the case of Spain, the recession is anticipated to be short-lived, with growth for 2023 as a whole still coming in positive.

The supply shock generated by the sharp rise in commodities prices, especially energy, is the main factor behind the global and European slowdown. Although price pressures have eased somewhat, the economy is still suffering despite the boost at the beginning of this year. Moreover, major central banks are becoming increasingly explicit in their willingness to cool demand to moderate the second-round effects of inflation.

Within this context, the November issue of *SEFO* starts off by presenting our most recent update on the outlook for the Spanish economy. The combined result of recent revisions to GDP figures reflect GDP growth of 6.7% year-on-year in the first half of 2022, up from the initially published rate of 6.3%, driven essentially by foreign demand, followed by investment, particularly in capital goods. That said, all signs point to an exacerbation of the slowdown increasingly on display in recent months, driven by the loss of household purchasing power as a result of inflation and the consequent increasing impact on household consumption. As well, the intensification of the energy crisis during the winter season could potentially lead to supply disruption, particularly in countries, such as Germany and Italy, which could lead to recession, with adverse consequences for Spanish exports. Growth this year is forecast at a solid 4.5%, up 0.3pp from our last forecast, albeit expected to be highly uneven by quarter and in terms of drivers. The economic weakness will be more tangible in 2023, when the Spanish economy is expected to grow by 0.7%, compared to our last forecast of 2% and inflation too is set to come down over the coming months, albeit remaining high. Geopolitical tensions are injecting a high degree of uncertainty into the forecast scenarios, with more downside than upside risk. Within this context, taming inflation, the economy´s ability to withstand rising interest rates and the persistence of the structural public deficit constitute the main risks for the Spanish economy.

We then turn our focus over to fiscal issues, specifically to the budget for 2023, currently

making its way through Parliament. While the 2023 Budget presented in early October is a vital document, the 2023 Plan presented to the European Commission one week later provides a more holistic approach for an analysis that takes into account upcoming fiscal measures designed to help vulnerable households and firms, which are set to have a material impact on both the revenue and expenditure sides of the budget equation. Indeed, the 2023 Budget starts from a 2022 tax revenue forecast clearly below the level derived by extrapolating tax collection figures available to date, which means that the rate of growth in tax revenues needed to deliver the forecast contemplated in this document will be much lower. Given that the government continues to target an overall public deficit of 3.9% in 2023, the figure established in the 2022-2025 Stability Programme presented last spring, the required deficit reduction will be much smaller, around one third of the initially contemplated amount. In short, per the 2023 Budget, there is little justification for concern over its consistency and sharply expansionary nature, failure to comply with the Country Specific Recommendation (CSR) or any mismatch between public spending and revenue. The healthy momentum in tax revenue in 2022 means the deficit and tax collection targets for 2023 are very modest and achievable, even if the macroeconomic situation ends up far worse than the government is forecasting. Nonetheless, the 2023 Budget is undermined by its omission of the fiscal package to be deployed in 2023 in response to the energy and inflation crisis which means that a more accurate assessment of the state of Spain's public finances in 2023 ultimately depends on the details of this package and its estimated cost. The probability of an economic downturn and the potential for a greater gap between revenues and costs thus calls for a highly selective package of additional fiscal measures to allow for some discretionary measures in case new needs emerge over the coming quarters.

Drilling down in greater detail, the 2023 Budget is underpinned by an optimistic GDP growth forecast (2.1%). It assumes a revenue-GDP elasticity of 1.1 and an expenditure-GDP elasticity of just over 0.6, which would unlock a reduction in the deficit from 5.0% in 2022 to 3.9% in 2023. On the revenue side, the forecast growth of 7.6% (at all levels of government) is shaped by the sharp growth in inflation (71.4% according to AIReF). Other contributing factors to the favourable revenue outlook include the measures set to take effect in 2023, with a net positive contribution to the state's coffers of 2.71 billion euros. The new sources of tax revenue stem mainly from essentially temporary measures (92.9% and 92.6% of tax revenue gains in 2023 and 2024, respectively) rather than genuine tax reform, as promised to Brussels for the first quarter of 2023 and upon which the release of 7 billion euros in European funds is conditional. On the expenditure side, the estimated figures are sensitive to the pending decision as to the rollover to 2023 of the household and business aid put in place in 2022, whose overall cost, if not adjusted, would be around 18 billion euros.

As regards Social Security, the indexation of contributory pensions is the main driver of the budgeted growth in Social Security expenditure in 2023. The increase in the number of pensioners and in the average pension could imply higher than budgeted spending. On the revenue side, the main development is the first-time application of an additional common contingency contribution of 0.6% to fund the so-called intergenerational equity mechanism. The separation of funding sources between contributory and non-contributory contributions, in line with the Toledo Pact recommendations, and the contribution to balancing the budget is addressed by state transfers, which now account for over 20% of non-financial income. The nominal deficit is forecast at 7.18 billion euros in 2023 and is once again covered by a new loan from the state. However, the overall hole in the contributory section of the Social Security system could reach 25.47 billion euros, equivalent to 1.8% of GDP. By year-end, the Social Security's debt with the state will stand at over 106 billion euros. The real problem, however, is not the volume of debt piled up with the state but rather the financial sustainability of the Social Security system in the medium- and long-term.

That is why it is important to accurately trace the expected trajectory in revenue and expenses, especially those related to the pension system, which will determine the system´s overall health.

In the last section of the November *SEFO,* we examine issues relevant to the financial sector. First, we assess recent ECB policy action, including both interest rate normalisation as well as changes to its monetary policy toolkit. Second, we look at some of the potential implications of those actions on lending, as well as loan quality.

The ECB is facing an extraordinary situation in which it is unable to rely on an economic slowdown alone to curb inflation. Reduced worker bargaining power has raised the risk of a cost-of-living crisis with a negative impact on consumption, without necessarily reducing underlying inflation, which apart from commodity prices, according to some economists, is being driven to some degree by global corporations' price– and margin-setting power. Only with decisive and swift action can the ECB exhibit its determination to bring inflation back in line with levels compatible with its symmetric target of 2% and keep inflation expectations solidly anchored. In line with these objectives, after 13 years of monetary accommodation, interest rate normalisation has begun in 2022 and is progressing at a rapid pace, despite still high levels of uncertainty, largely underpinned by geopolitical tensions arising from the invasion of Ukraine. As well, the ECB this year has also embarked on normalisation of its monetary policy toolkit. Instruments, such as its longer-term refinancing operations (TLTROs) and its asset purchase programmes, a significant legacy from the last period of monetary accommodation, are in the process of being unwound, bringing about a reduction in the size of the ECB´s balance sheet.

Specifically, the European Central Bank's special liquidity facilities known as targeted longer-term refinancing operations, or TLTROs, were designed to be one of the key mechanisms for monetary policy transmission via the banking system by providing the latter with a source of stable long-term funding on highly favourable terms, essential to keeping credit flowing. Although the purpose of those rounds of financing was to boost the provision of credit to the real economy, the truth is lending barely grew, primarily due to scant demand in the context of deep macroeconomic uncertainty, firstly due to ensuing pandemic developments and later due to the energy crisis aggravated by the invasion of Ukraine. The advantageous TLTRO terms intrinsic in the design of these instruments now clash, however, with the new monetary policy objectives implemented by the ECB to halt inflation: rapid rate hikes and liquidity absorption via the withdrawal of its unconventional asset purchase programmes. The TLTROs, as currently configured as regards cost and terms, constitute somewhat of an anomaly in the prevailing context of monetary tightening, which is why the ECB, at its last Governing Council meeting, changed the terms applicable to the various rounds of TLTROs in order to better align them with those of other key monetary policy instruments. Beyond the negative impact on their earnings of the elimination of that source of liquidity and the associated carry trade, foreseeably offset by the favourable effect of the rate increases on their net interest margins, the European and Spanish banking systems have sufficient liquidity to handle the maturity or, if they so decide, prepayment of their TLTRO funds thanks to their excess reserves. Meanwhile, growth in retail deposits and funds and bond market issuance is expected to be sufficient to cover the anticipated growth in credit next year.

All of this policy action at the ECB level will have implications on borrowers at the country level within the EU. Rising interest rates are translating into a considerable increase in borrowing costs over a short period of time. Households and companies will face difficulties in tackling this situation not only because of tighter financing conditions, but also because they come in the wake of a very long period of exceptional financial and inflationary circumstances. As of last August, the average rates being charged in Spain were still below the European average

in 12-month consumer loans (4.16%) but were higher (7.39%) in longer-dated paper (up to 5 years). In the mortgage segment, the average rate being charged is among the lowest in the eurozone, France being the only one of the larger European economies to charge less (1.58%). In the first eight months of the year, average mortgage rates climbed 0.59 percentage points higher. As for business lending, the rates trend is less consistent. In the wake of notable growth in 2020 (6.3% year-on-year), fuelled by the support and public guarantee schemes rolled out during the pandemic, growth in lending has slowed significantly and has become more volatile, contracting, for example, by 0.2% in June only to register growth of 2% in August. On the whole, in Spain, lending has slowed in the wake of the efforts made to keep credit flowing to the private sector during the pandemic, mostly targeting the business segment. Specifically, the increase in interest rates is already materialising in a degree of retrenchment in lending activity, particularly in the mortgage segment.

Apart from impacting lending dynamics, it will also be important to assess the impact of ECB policy action on loan non-performance across euro area banks. Despite the intensity of the two crises sustained by the Spanish economy in the last three years (the COVID-19 crisis and the energy crisis exacerbated by the Ukraine-Russia war), the Spanish banks' non-performing loan (NPL) ratio has not increased, in part thanks to the measures rolled out to mitigate the impact of those events (furlough and credit relief schemes, *etc.*). However, in the corporate segment, a detailed analysis by sector reveals considerable differences in absolute NPL ratios and in the trend in recent years. Although a majority of sectors has reported a decrease in their NPL ratios, in those more vulnerable to the impact of the pandemic, that ratio has increased, for example, in hospitality (whose NPL ratio has increased by 4 pp to 9.26%) and activities related with leisure and entertainment (up 7.6 pp to 14.75%). By comparison with the EU, the arts, recreation and entertainment sector stands out sharply, with an NPL ratio in Spain twice the European average. Given the downward revision of GDP growth forecasts for 2023, with high inflation leading to rate hikes and the attendant tightening of financing conditions, non-performance will in all likelihood hit an inflexion point in the coming months. Against that backdrop, the banks would be well advised not to relax their provisioning policies, in line with guidance from supervisory authorities.