Letter from the Editors

The international context has improved somewhat in Europe and beyond since the previous November issue of *Spanish and International Economic & Financial Outlook (SEFO)*. While the global landscape remains highly uncertain, some of the factors behind the surge in inflation and the current phase of economic weakness seem to have receded in recent months. First, energy prices – the main source of the "stagflation" shock – have moderated significantly to price levels present before the outbreak of the war in Ukraine, facilitating the de-escalation of energy inflation. This, combined with the unusually mild winter in Europe so far, has helped to reduce the risks emanating from the spectre of a gas supply cut. While geopolitical risks remain high, the worst-case scenarios that were weighing on business and consumer confidence over the past year (spillovers from the war, nuclear threat, *etc.*) are now looking less likely. Indeed, in its latest forecast for 2023, the ECB predicts positive growth in the eurozone of 0.5%.

Within this overall macroeconomic context, we start off by examining the outlook for the global economy in 2023. The global economy is heading into the new year trying to digest the nasty surprises ensuing since the beginning of 2020, which have ushered in the biggest imbalance between supply and demand of recent decades. The pandemic, the bottlenecks in international shipping, the war in Ukraine and the surge in energy prices have altered the dynamics that have driven business cycle patterns since the financial crisis of 2008. That accumulation of shocks is proving a challenge for economic policy response in the short-term and threatening to alter the ecosystem in which the global economy has been moving since the end of the 1970s, characterised by flexibility and maximisation of production efficiency via global value chains. Although there are more questions still than answers about how this process will play out and a good number of fronts are still open, 2023 should shed some more light on key future international economic trends. While it is too soon to rule out the odd quarter of contraction in one of the major economic blocs, current signs point more to a relatively soft economic landing, without traumatic effects on employment, rather than to a full-scale recession. Indeed, the global economy could grow by around 2.5% in 2023, although with a significant slowdown in growth in both advanced economies and emerging economies. In the near-term, the key lies with the trend in inflation, the real barometer for the instability sustained by the economy in recent years. The search for new equilibriums in prices, economic policy and geopolitics will be among the main variables to watch in 2023.

We then drill down on economic perspectives for Spain, presenting our latest economic forecasts. After upward revisions in the first and second quarter GDP figures, growth in the first half of last year stood

at 7.3% year-on-year, up from the initially published 6.7%, while GDP rose just 0.1% in the third quarter of 2022. The combination of labour market resilience and an easing of inflationary pressures arising from lower energy prices, coupled with higher than anticipated natural gas storage levels in Europe, means that the economy is likely to have performed better towards the end of the year than initially thought. Meanwhile, the public deficit continues to beat expectations, once again thanks to higher than forecast tax revenue. As of September, the overall deficit was running at 2.3% of GDP, compared to 6.3% in 9M21. The adjustments made by the National Statistics Office to the initially reported GDP figures, coupled with the let-up in energy prices, have prompted an upward revision to our growth forecasts. In 2022, we are now expecting GDP growth of 5.2%, up 0.7pp from the last forecast, as a result of the new official figures. Growth is expected to fall back to 1% in 2023, mainly because Spanish households no longer have a savings buffer to prop up their consumer spending. With the broader European economy gradually rebounding, growth is forecast at 1.8% in 2024, which would finally put the Spanish economy back at pre-pandemic levels. The government deficit is forecast at 4.3% of GDP in 2023, with public debt at 110%. Those readings should improve in 2024 in tandem with the economic recovery. These forecasts remain subject to a significant level of global uncertainty. But fiscal sustainability will depend on the credibility of the targets set for correcting current imbalances and the transformational nature of the investments financed using the NGEU funds.

Subsequently, we shift our focus to monetary policy, first looking at the challenges and implications of the unwinding of QE at the EU level. And then specifically to the perspectives of monetary policy for the year ahead, and what this means for banks.

The Governing Council of the European Central Bank (ECB) agreed on October 27th, 2022, to encourage early repayment of loans given out to banks through targeted long-term refinancing operations during the COVID-19 pandemic. On December 15th, the Governing Council announced that it would slow down the reinvestment of the maturing principal on assets held within the large-scale asset purchase programme to shrink those holdings by roughly €15 billion per month starting in March 2023. These two decisions are important to reduce surplus liquidity in the euro area and to improve the functioning of the ECB's monetary transmission mechanism. Nevertheless, they pose important risks for commercial banks, central banks, government finances, and the ECB itself. Managing those risks will progressively dominate concerns in the Governing Council as the pace of interest rate rises that started in July 2022 begins to slow in the second quarter of 2023.

In 2023, the effort to fight inflation will go beyond the battle for economic and financial stability, with the institutional credibility of monetary policy itself in play. The roadmap looks set, marked by successive official rate increases for at least much of the year. Pricing in monetary policy changes, EURIBOR has traded significantly higher since July 2022. That said, the average rates effectively applied by the Spanish banks have increased more gradually. After initial sharp upward movements, the benchmark rate appears to have largely discounted the monetary policy shift and the outlook for further official rate hikes, so that it should sustain lower growth in 2023. Within this context, just as the banks have played a crucial role in providing credit during the pandemic, they will remain key in the prevailing uncertain climate. It is important, however, to consider their situation from a broad perspective. Several recent studies by supervisory bodies suggest that, although the banks' income could increase on the back of higher rates, they face a number of challenges, some bigger than others, including higher funding costs, shrinking lending volumes and an uptick in non-performance due to economic weakness.

The changing interest rate dynamics are also having an important impact on corporate financing in Europe, with the role of the banks increasing its significance once again relative to

the capital markets. It has long been assumed that corporate financing in Spain (and Europe) was overly reliant on bank lending to the detriment of the capital markets, in contrast to the US model, where corporates tapped the markets far more intensely. To that end, in 2015, the European Commission launched its Capital Markets Union (CMU) initiative with the clear aim of correcting that bias, prompting a significant number of Spanish and European companies to début as bond market issuers. Tension in the corporate bond market since the start of the inflationary spiral towards the end of last year has driven a sharp increase in secondary market rates, as well as a sharp contraction in primary market issuance, making it impossible for many of those companies to tap the markets, forcing them back to the bank channel they had previously abandoned. That has led to a rebound in lending volumes to large enterprises, which are taking advantage of the fact that although the banks have increased the interest rates they charge for those loans, the increase has been less intense than the spike in market funding costs. As an example, activity in the Spanish corporate bond market, which had been registering strong growth since the middle of the last decade, in terms of both issuance volume and number of issuers, totally collapsed in 2022, accompanied by a very sharp increase in average yields on that market to over 4%. That said, indeed, bank and market corporate finance are compliments, rather than substitutes, with the banks acting as a back-up option when the bond markets are temporarily unable to finance the productive apparatus. The banks' role is all the more noteworthy considering the fact that they themselves have also seen their ability to issue affected by the bond market crisis.

Lastly, as regards the banking sector, this *SEFO* assesses the relevance and recent performance of the bancassurance sector in Spain. Of the 199 insurance providers doing business in Spain, 33 have ties to the main banking groups. Their weight in the country's insurance business, especially the life insurance segment, and their contribution to their parent banks' domestic earnings are very significant. As a result, the bancassurance business has been key to propping up the banks' earnings during periods of significant loan loss provisioning. That is true of the banking crisis of the last decade and, more recently, the COVID-19 crisis. Even during more normal times, the relative contribution of the bancassurance business to the banking sector's earnings is very substantial, lending earnings stability and solidity to the banks with the most developed such businesses.

We close this *SEFO* with two articles related to Spanish corporates. First, we analyse the recent external competitiveness of the Spanish economy. Second, we explore the level of digitalisation of Spanish companies in a European context.

The piece on external competitiveness explores whether there are any signs that the prevailing inflationary dynamics could be undermining the competitiveness of Spanish goods exports. The analysis encompasses the euro area's five largest economies: Germany, France, Italy, Spain and the Netherlands. Spanish exports registered nominal growth of 40% between 2012 and 2021, the highest rate among the five benchmark economies. The data corresponding to the first three quarters of 2022 suggest that momentum has continued, with Spain ranking as the country with the second-highest export growth compared to the same period of 2019. Analysis of the cost-competitiveness data suggest that the Spanish export sector has been competitive on the cost side, both before and since the pandemic-induced crisis. Thus, the Spanish economy is capable of improving its internal cost competitiveness and transforming those gains into export growth. In addition to this, it is likely that some Spanish firms are positively affected by the current reorganization of globalization, leaning towards shorter and safer supply chains. Nevertheless, Spain's export intensity remains below its weight as an economy within the universe of benchmark economies.

The European Company Survey (ECS) 2019 data show that business digitalisation is a multidimensional phenomenon marked

by heterogeneous patterns. Differences in digitalisation at the firm level across Europe are attributable to country factors (productivity differences), sector-market factors (technology and demand) and company factors (size, competitive advantage, organisational capital). Public policies designed to support digitalisation across Europe need to take these factors into consideration. In contrast to the Spanish economy's relatively low productivity levels, overall, Spanish companies are relatively highly digitalised. In fact, they rank among the highest in the EU. However, a high percentage of Spanish companies use digital technology to control worker performance (relative to alternative uses in companies in more productive countries) and have relatively low levels of organisational capital (complementary to digital capital). This, together with the lower incidence of delegation among the Spanish companies, could mean that they are missing out on the opportunity created by their investments in digitalisation to lift productivity.