Letter from the Editors

Concerns about global economic prospects have intensified since the last issue of *Spanish and International Economic & Financial Outlook (SEFO)*. The OECD's June forecasts project global growth of 3% this year, down almost 1.5 points from its prior estimate, and the organisation has flagged the risk of stagflation. The invasion of Ukraine has compounded existing tensions in the energy and commodities markets, spilling over to other prices and driving inflation to levels not seen in the developed world since the 1980s. Importing nations, notably including the EU, are facing a loss of purchasing power that is weighing on the recovery expected in the wake of the pandemic. The inflationary environment is prompting monetary policy tightening, led by the Federal Reserve, followed by the ECB.

Given the importance of the monetary policy shift to the economic outlook for Europe and Spain, we start off the July issue of *SEFO* with a focus on the ECB´s policy debate. The European Central Bank's Governing Council faces a conundrum as it speeds up the withdrawal of stimulus to tackle accelerating inflation. The rapid tightening of monetary policy and expectations of its future path threatened to incite financial market fragmentation through widening spreads on sovereign bonds across the eurozone over the spring of 2022. The Governing Council of the ECB must walk a fine line between unwinding its unconventional monetary policy tools, while preventing the fragmentation of European financial markets and potential disruption of the monetary transmission mechanism. This challenge is complicated by the fact that much of the potential for disruption lies in the minds of market participants. In order to maintain the ability to shape market expectations, the Governing Council requires credibility, yet that credibility suffered a hit as the ECB had to walk back much of its forward guidance from late 2021. Fortunately, the Governing Council appears to have a plan, and that plan appears to be working. The next two meetings will be crucial in deciding just how much it can deliver.

Within this context, the July *SEFO* then takes a look at the economic prospects for the Spanish economy. Despite an extremely modest expansion in the first quarter of the year, Spain's economy is still expected to grow by 4.2% in 2022. Investment, goods and non-tourism services exports and tourism are expected to drive growth until the third quarter. Thereafter, headwinds related to inflation, high energy prices, geopolitics and more restrictive monetary policy will cause growth to slow significantly. GDP is expected to grow by 2.0% in 2023 (lower than the previous March forecast of around 3.3%). Over the forecast horizon, high and persistent inflation is expected to dampen households' purchasing power and real consumption. Investment will still be supportive, partly driven by Next Generation EU (NGEU) funds. While the pace of job creation should slow, the unemployment rate could fall below 12% by the end of the projection period. Spain's balance of payments should remain favourable with strong tourism earnings offsetting rising energy import costs. As growth slows into 2023, household and corporate balance sheets appear to be in a position to sustain higher interest rates, especially when compared to the 2011-2014 financial crisis. Public finances are more vulnerable to the turn in monetary policy. They should remain sustainable if growth continues and deficits are gradually reduced. Risks to growth include geopolitics (war in Ukraine) and higher energy prices, along with monetary tightening and the prospect of fragmentation in eurozone financial markets.

We then shift our attention to inflation and its possible implications. Major monetary policy decisions were taken in June to curb rising inflation, which increasingly exhibits considerable structural traits. While central banks are acting, they acknowledge that if the exogenous supply factors contributing to high inflation persist, more aggressive measures would be needed. Central bank action also appears to be more aggressive than initially contemplated in response to rising market expectations. The timing of interest rate hikes should be cautious, due to possible impacts on consumers and businesses, especially if the economy and labour market were to deteriorate. To the extent that inflation remains at elevated levels (even less than present), the real interest rate will remain clearly negative. One of the markets most exposed to the rate environment is the property market and, relatedly, the mortgage market, albeit the impact in Spain is expected to be moderate. In Spain, new home prices increased at 10.1% year-on-year in the first quarter of 2022, with resale house prices not far behind, at 8.2%. Concurrently, home mortgages have been growing at around 1.2% year-on-year in recent months. Despite the sources of concern and uncertainty, business lending has been growing at a rate of 1% to 1.7% year-on-year from January to April 2022, but risks are rising. One such risk is a higher-than-expected increase in borrowing costs, especially if the sovereign risk premium rises, which would have significant knock-on effects for private sector financing.

Rising inflation and the subsequent monetary policy response will also impact sovereign yield curves. The upward shift in yield curves since mid-2021 carries major implications for European banks. On the positive side, interest rate tightening foreshadows a period of increasing short-term rates, which will support retail bank net interest income following five years of negative rates and downward pressure on margins. On the negative side, rate hikes portend adverse effects for European banks through two channels: i) higher borrowing and energy costs may impact households' and businesses' ability to service their debts with implications for rising non-performing loans; and, ii) the direct and immediate losses on public debt securities held by the banks on their balance sheets. The effect of losses on bank balance sheets related to public debt securities threatens reviving memories of the sovereign-bank risk loop unleashed in the eurozone between 2010 and 2012 via the bank-public debt nexus, but there are noteworthy mitigating factors. In the case of Spain, two factors mitigate the fact that domestic sovereign debt exposures are slightly above the European average in terms of their sensitivity to impairment losses on those portfolios. The first is the average maturity of the public debt portfolios, which is shorter in Spain than in Europe and the second is how those exposures are classified for accounting purposes, which, among other things, translates to lower volatility.

The ultra-low rate environment has also exerted pressure on banks' net interest income, forcing them to seek out alternative sources of income in order to generate returns at the level expected by investors. The average net interest margin hit a record low of 0.8% of assets in 2021, dropping to 49% as a share of total income. In parallel, fee and commission income has increased, and now accounts for 31% of total income. The composition of both interest income and fee mix has also evolved over the years.

Compared to European banks, Spanish banks stands out for having the highest share of interest income in total earnings and among the lowest share of fee and commission income in total earnings. Fee and commission income, measured as a percentage of average total assets, is in line with the eurozone average.

Finally, within the financial sector, we assess the implications of the current economic environment on the insurance sector. The bottlenecks caused by the pandemic and the war in Ukraine are sending prices soaring and leading to inflationary pressures not seen in decades. Major central banks have announced sharp and sustained rate hikes, while clouds have gathered over forecasts for Spain´s economic growth. Spain´s insurance sector has traditionally proven highly resilient and capable of adapting to shifting market environments. The changes taking hold will impact the sector's investment portfolios and trigger a business response mainly in life insurance and traditional savings products, which have suffered from under-development in recent years due to a period of protracted low interest rates. The anticipated economic slowdown could also negatively impact demand for certain non-life products. Finally, inflation is expected to increase the costs of claims as not all segments can pass on rising costs to client premiums.

Lastly, we close the July *SEFO* with an analysis of the impact of the pandemic and the post-pandemic recovery within Spain´s manufacturing sector. At the headline level, the Spanish manufacturing industry appears to have fully overcome the harsh effects of the pandemic, with revenue and hiring back to pre-pandemic levels. However, the new geopolitical paradigm and supply side frictions are weighing on growth once more. The situation in the transport materials sector is of particular concern, with revenue and employment still 10% and 8% below 2019 levels. Meanwhile, other sectors have fully recovered and have grown revenues and workforces above pre-pandemic levels, except for the textile and clothing and the paper, publishing, and graphic arts sectors. While revenue is back above pre-pandemic levels for these two sectors, firms have taken advantage of the pandemic to find efficiencies and downsize their labour forces. At the opposite end of the spectrum, sectors experiencing strong sales growth, such as the food, beverage and tobacco and chemicals and pharmaceuticals sectors, are generating new jobs.