Letter from the Editors

The September issue of *Spanish and International Economic & Financial Outlook (SEFO)* comes out within the context of signs of a weakening external environment, which have become more entrenched since our July issue.

EU GDP stagnated in the second quarter, dragged down by recessionary forces hitting some of the most industry-heavy economies, such as Germany among others, and expectations for the coming months have cooled. The outlook has been affected by higher interest rates, the downturn in international trade and the bursting of the credit bubble in China, with its global spillover implications, particularly for the industrial sector. Rising energy prices and the depreciation of the euro are also hampering the disinflation process. The US economy is holding up better, although the latest trends also point to a slowdown.

Under this more pessimistic backdrop, it is ever increasingly important to assess the EU's and Spain's fiscal and growth prospects going forward. Thus, we open the September issue of *SEFO* with perspectives on the upcoming post-pandemic euro area fiscal adjustment process. The fiscal response to the COVID-19 pandemic added significantly to European public debt. This was only to be expected, and in March 2020 the European Commission triggered the 'general escape clause' of the Stability and Growth Pact to accommodate the need for greater public spending. That 'general escape clause' will be deactivated on 31 December 2023. Whether or not there is a reform of the rules for European macroeconomic policy coordination, policymakers across Europe will need to begin consolidating their fiscal accounts in preparation. Such efforts will be particularly important for the six European Union (EU) member states with public debt worth more than 100 percent of gross domestic product (GDP). The high rate of inflation in the wake of the pandemic has eased some of that adjustment burden, but the swift monetary tightening introduced to calm rapid price increases will add to the challenge.

Shifting the focus to another key element of Spain's relationship with the EU, the next article in this *SEFO* provides a detailed account of Spain's progress on allocation and implementation of Next Generation EU (NGEU) funds. By the end of 2022, Spain had called tenders and grants for 43.7% of the NGEU funds allocated thus far. If we compare the volume of calls (35.83 billion euros) with the amount awarded as of year-end (16.35 billion euros), we arrive at an implementation rate of 45.6%, with more than half of the volume called yet to be allocated. Of the volume already awarded, almost three-quarters (73.4%), or 12 billion euros, have gone to the business community.

Of the aid awarded to Spanish businesses, more than half has gone to large enterprises (59.3% of total), with SMEs receiving 40.7%. By sector, the services sector has been the biggest beneficiary so far (46.9% of the total), followed closely by construction (41.6%). Within services, the information and communication sector (15.4% of the total) and wholesale and retail trade (12.1%) have been the biggest recipients. In manufacturing, a noteworthy 3.6% of the aid has gone to the automotive sector. Under the current scenario, Spain will have to accelerate the implementation process if it is to use the rest of its non-reimbursable funds by the August 2026 deadline.

Next, given the importance of the interest rate cycle in so many aspects of the economy and the financial sector, we dedicate the subsequent segment of this *SEFO* to evaluating the situation across a broad range of actors following one year of interest rate increases. At least two generations of labour market participants had never experienced positive real interest rates and were paying very low rates on their borrowings until just over a year ago. Today, monetary policy remains immersed in an intense and complex battle to stem inflation. The most obvious consequence has been a quick succession of interest rate increases. In the eurozone, the price of money has been rising for over 18 months, significantly increasing borrowing costs for households, companies, and governments. Credit has already contracted substantially, and the cost of debt has increased. Indeed, the increased cost of money has driven a slowdown in mortgage flows to year-on-year rates of growth of 2.5% as of July 2023. At the same time, however, the banks' pre-tax earnings over average total assets had increased from 0.8% to 1.1% in the first quarter of 2023 and the spread between asset and liability rates had increased by just 0.1pp to 1%. Lastly, the cost of public debt has increased considerably. Since 2021, the cost of issuing 3-year bonds in Spain has increased by 3.75pp, while the cost of issuing 10-year paper has increased by 3.16pp. As acknowledged by the heads of the central banks themselves, it is unclear how long it will take for these policies to have their intended effects. The monetary authorities' key message is that the approach has to remain conditional until uncertainty around inflation dissipates.

We then look specifically at how those rate hikes have hit the European financial sector through the lens of their performance on the most recent round of stress tests. In keeping with the stipulated biennial schedule for stress testing significant banks, the European supervisor (ECB/SSM) has completed its exercise for 2023-2025, using year-end 2022 as its starting point. In parallel, its American counterpart (the Federal Reserve) has stress tested its significant banks, publishing its results one month ahead of the ECB. Several aspects distinguish this set of tests from those undertaken since 2014 when, in conjunction with the launch of the Banking Union initiative, it was decided to place stress tests at the heart of the supervisory function. The last round of tests (in 2021) focused on the potential impairment of credit as a result of the pandemic at a time when interest rates of zero per cent were preventing the banks from generating reasonable minimum margins. Compared to the zero-rate environment that shaped all the previous stress tests, the 2023 tests are the first to take place against the backdrop of high rates that are unlocking new risks (market, interest rate and liquidity risks) that did not affect the previous rounds of tests. It is for that reason that the European and American supervisors have tentatively introduced the simulation of bond portfolio loss scenarios related with the spike in interest rates, albeit as an exploratory exercise with no immediate impact on capital requirements. While the general conclusion derived from the exercise is that the European banks are better positioned to offset potential capital depletion via stronger NII generation (as is also apparently reflected in the listed banks' market values), the upward shift in the rate curves is impacting the economic value of the banks' investment portfolios. Against this backdrop, the stress tests are and must remain a constantly evolving tool capable of adapting to new sources

of risk and new types of scenarios, notably including climate, cybersecurity, geopolitical and pandemic risks, that are not captured in scenarios that only consider stressed financial conditions but can nevertheless wreak havoc on the economy and, by extension, the health of the banking system. The supervisors need to continue to boost the quality and effectiveness of their methodologies in order to look forward and ensure that the banks remain able to carry out their financial intermediation role, especially in times of heightened uncertainty.

Relatedly, even though EU banks performed relatively well on the stress tests, given the latest bout of financial markets turbulence resulting from the fallout of Silicon Valley Bank in the US, we take this opportunity to ascertain some of the ECB's medium-term supervisory policy priorities. Compared to the recent episodes of financial instability in the US and Switzerland, where several banks suffered structural balance sheet issues forcing their intervention and/or acquisition by other banks, the European banks' earnings and capital structures look relatively strong. Without question, this is largely thanks to the intense regulatory and supervisory activity undertaken by the European authorities focused on avoiding episodes of stress similar to those observed in other geographies. Nevertheless, recent developments have highlighted the need for banks' business models to focus on risk-adjusted returns, with high interest rates favouring the maturity transformation business. Elsewhere, the banks will inevitably have to address regulatory changes related to liquidity buffers, as recent events have shown these may potentially mask underlying issues. Lastly, going forward, the focus should be on strengthening the banks' capital and liquidity self-assessments, as this will help improve dialogue with supervisory authorities, while at the same time demonstrating the viability of their business models, hence underpinning stable performance of business activities and the correct functioning of credit channels.

Subsequently, we analyse the impact of the current rate tightening cycle, in the context of ECB policy "normalisation", on the central bank's balance sheet and excess liquidity. Eurozone monetary policy has become far more sophisticated since the onset of the Global Financial Crisis in 2007-2008. Although the ultimate price stability target has not changed and overnight rates remain the channel for policy transmission to the economy, the ECB's balance sheet has taken on greater purpose relative to its traditional role as a support instrument for monetary policy, entering the field of financial stability and influencing not only overnight rates but also the entire rate curve via new and less orthodox instruments. This situation has led the ECB, along with most of the central banks, to build up a balance sheet of an unprecedented size. Indeed, excess liquidity currently stands at 3.6 trillion euros, compared to 4.8 trillion in September 2022. The situation has sparked controversy, such as that surrounding its remuneration structure; misunderstandings with respect to the importance of quantities in monetary decisions; and unknowns, including questions about the exit strategy and impacts on bond market premiums. Against that backdrop, with the ECB since 2022 on a policy path of "normalisation", it is timely to ask what that implies and whether it is possible to return to the way things were prior to 2007. Given that excess liquidity is determined by factors exogenous to monetary policy and can coexist with it indefinitely, even if the policy stance is restrictive, as it is now.

We then switch gears to focus on more socio-economic issues and, where applicable, take a deep dive into some of the direct and indirect effects of the latest wave of inflation. One key topic within this space is the issue of youth housing affordability in Spain. This issue is particularly pronounced in Spain and appears to have worsened in recent years. This may well be related to other socio-economic problems, such as the increase in the age at which young Spaniards are leaving home to above the age of 30, compared to an EU average of 26.4. The lack of a stock of an abundant supply of houses for rent at affordable prices is one of the biggest

causes. Interestingly, despite the labour market challenges facing the Spanish youth, this does not appear to be the main factor affecting youth housing affordability in Spain. The solution to this problem therefore involves increasing supply, particularly in the rental segment. There are a host of international experiences to look at. Increasingly, given constraints to public treasuries for spearheading the required increase in supply via public sector investment, responses are taking the form of targeted incentives designed to provide young people with more affordable options.

To conclude this *SEFO*, we then examine the impact that inflation has had on the rising VAT burden for Spanish households. Value added tax (VAT) receipts soared in 2021 and 2022, by 14.9% and 13.4%, respectively, according to the Spanish tax authority (AEAT, 2023). This dynamic was buoyed by the tailwind provided by rampant inflation, which jumped from 3.1% in 2021 to 8.4% in 2022. An analysis of the increase in the VAT borne by households those years and how much of the increase is attributable exclusively to the inflation phenomenon shows that Spanish households' total VAT burden increased by 263.6 euros on average in 2022, of which 138.2 euros (52.4%) is directly attributable to inflation. The VAT burden accumulated between 2021 and 2022 exclusively as a result of inflationary pressures averaged 297 euros. That sum increases to approximately 350 euros for a standard household with a level of spending similar to average household income in Spain in 2022 (32,200 euros).

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