Letter from the Editors

Sadly, the November issue of *Spanish and International Economic & Financial Outlook (SEFO)* is the second to be published in the last few years within the context of the outbreak of yet another geopolitical conflict – this time in Gaza. As a result, the economic environment is currently characterized by heightened uncertainty. The modest advance of the eurozone economy recorded in the second quarter has given way to a decline in the third quarter, and the most recent indicators point to a further contraction at the end of the year. The US economy seems to be holding up better to the impact of monetary policy tightening, with GDP rising in the third quarter. However, signs point to an exhaustion of some of the factors behind the rebound, such as stockpiled savings. China, for its part, continues to be weighed down by weakening domestic demand and the bursting of the real estate bubble. In parallel, given the intensification of trade tensions, the IMF has cut its forecast for international trade, a scenario which is particularly detrimental for open economies, such as those of the EU. Indeed, the European Commission has once again cut its GDP growth forecast for the EU, to 0.6% in 2023 and 1.3% in 2024.

Relatedly, we focus the November *SEFO* on the economic and fiscal outlook for Spain. The forecast for GDP growth has been revised to 2.4% in 2023, up 0.2% from our projection in July, underpinned by the strong momentum at the start of the year, driven mainly by internal demand. Both public and private consumption have picked up strongly. However, a slowdown is underway and will become more palpable in the near future, due to the weaker external context, the exhaustion of household excess savings and the delayed impact of higher interest rates. Economic growth is projected at 1.5% in 2024, down 0.1 percentage points from our previous forecast. Yet, the favourable growth differential with respect to other EU countries would be maintained. The let-up in CPI should gain traction once the impact of the reversal of the current anti-inflationary measures has dissipated. Spain's key source of vulnerability in the short- and medium-term is the country's fiscal imbalance at a time when sovereign borrowing costs are rising sharply. Hence the importance of taking advantage of the opportunity afforded by the prevailing economic growth to embark on a roadmap for fiscal consolidation.

Delving into the GDP outlook, we next explore the recent revisions by Spain's National Statistics Institute to growth figures. September's annual revision of Spain's national accounts data for the years 2020 to 2022 resulted in an upward adjustment to the initial forecast for GDP growth figures for 2021 and 2022, supported by substantial revisions to the components of GDP growth. The revised figures show that Spain reached pre-pandemic growth levels in the third quarter of 2022, and not the first quarter of 2023, as previously estimated. Indeed, as of the second quarter

of 2023, Spanish GDP was actually 1.8% above the pre-crisis threshold, compared to the 0.4% improvement gleaned from the prior statistics. On the demand side, private consumption played a bigger role in underpinning GDP growth than initially expected. Meanwhile, export performance and investment in capital goods were less supportive than previously anticipated. On the supply side, the manufacturing sector made a stronger contribution than previously thought and wage compensation rose to a higher degree than originally estimated. On the positive side, it is worth highlighting the Spanish manufacturing sector's strong performance, in particular relative to the eurozone average. On the downside, the weakness observed in investment, in particular capital goods investment, is concerning, especially given Spain's sizeable funding allocation under the NGEU program.

In our exploration of the recent performance and outlook for Spanish GDP growth, we take a deep dive to examine the performance of one of Spain's key historical growth drivers – the tourism industry. The high expectations for the recovery in international tourism appear to have been met this summer by comparison with 2019, particularly in terms of average daily tourist expenditure. Although changing dynamics within the sector are worth consideration. Firstly, there have been some shifts across the traditional source markets. While France has performed well, increasing its market share, the UK and Germany have relinquished part of their market share, reducing the aggregate commanded by these three markets to 47.4%, relative to levels of around 49% back in 2019. This shift has been accompanied by an increase in tourists from the Americas, with higher purchasing power. As well, although there are notable doubts about the outlook for the Chinese economy, there is still considerable upside emerging from the fact that Chinese visitors, who also generally command above average purchasing power, may increase now that all COVID-related impediments on tourism have been removed (since August). These two trends support an encouraging outlook for the sector heading into 2024. Lastly, Catalonia has fared poorly relative to the other main destinations within Spain, which are all back to pre-pandemic levels. Among other factors, overtourism may be behind the weak results posted by Catalonia in terms of both tourist numbers and their average daily spend. It is still premature to ascertain whether those numbers are the result of a slower recovery or a change in international tourist preferences around this destination.

After years of expansionary fiscal policy, in part to counteract the effects of the pandemic crisis, the next segment of this *SEFO* analyses recent performance and the outlook for Spain's fiscal accounts. Growth in total state revenue is expected to slow from 6.7% to 5.8% in 2024, despite: (i) expiration at the end of 2023 of tax breaks on energy and food products worth 8.4 billion euros; and, (ii) a 6 billion euro boost from temporary taxes (on the financial and energy sectors and large fortunes) and a reduction in parent-subsidiary loss offsetting in 2024. Growth in public expenditure is forecast to slow from 5.0% to 3.8% in the coming year, also supported by the expiration of over 9.1 billion euros of professional and sector-specific assistance and fuel subsidies. However, wage and state pension increases will raise structural spending by around 12 billion euros in 2024. In short, delivery of the targeted budget deficit of 3.0% of GDP will prove a challenge for the new government in the year of reinstatement of the EU fiscal rules, severely limiting its ability to introduce new measures to support households or corporations in 2024 without running the risk of missing its deficit target. Moreover, the government will have to overcome additional obstacles on its path towards fiscal consolidation, including maintaining a cap on public spending in line with EU recommendations, servicing the higher interest burden on public debt, and financing growing pensions expenditure under the current inflationary climate, resulting in a greater opportunity cost for other necessary policies.

We next contextualize Spain's fiscal outlook by framing the scenario under the new paradigm

of anticipated fiscal consolidation within the EU. Spain's public finances deteriorated as a result of the pandemic, with the deficit soaring to 10% of GDP and public debt levels reaching historical highs of 120% of GDP. Since then, the reactivation of the economy and significant growth in tax revenue helped to underpin improvement in the country's fiscal metrics; however, projections indicate Spain will record persistently high structural and overall deficits going forward unless further fiscal adjustments are implemented. As well, with the deactivation of the Stability and Growth Pact (SGP) escape clause in 2024, increased budget consolidation efforts will be needed in Spain. Meanwhile, the ongoing debate over the reform of EU fiscal rules is complicated by the divergent fiscal positions across EU countries as well as disparate views over the need for flexibility *versus* budget stability, resulting in increased challenges in reaching a consensus. In any event, under the anticipated stricter fiscal framework, fiscal consolidation in Spain will face significant hurdles, due to increased defence spending, investments designed to accelerate the energy and digital transitions, population ageing and climate change, which is expected to hit Spain particularly hard. Going forward, the EU should take a more active role in financing investments, while in parallel, Spain should accelerate progress on reforming the fiscal system, taking into consideration the particularities of the Spanish fiscal federalism framework.

The last section of this month's *SEFO* assesses the situation in the financial sector, taking into account some of the impacts related to the rapid rise in official rates that we have seen across global central banks, not least the ECB, over the past year and a half.

On the asset side of the balance sheet equation, we take a look at how the high interest environment has been affecting households' decisions on a key product for Spanish banks – mortgages. After 18 months of rate tightening, marked by an accumulated increase of over 4pp, the increases have by now been passed through to virtually all mortgages taken out at floating rates (two-thirds of the total stock of mortgages). That pass-through, which has been gradual but very consistent (in line with the contractually stipulated repricing schedules), contrasts with the slower pace of deposit repricing. Against this backdrop of high borrowing costs and relatively lower returns on savings, the prepayment of borrowings, especially those more affected by the rate increases, such as floating-rate mortgages, has emerged as a clear alternative to investing savings. Considering the long-run stability around monthly mortgage cancellations of approximately 26,000, we can infer that the incremental number of cancellations attributable to the increase in rates between June 2022 and June 2023 was around 6,000-7,000/month, which would put the cumulative number of mortgages prepaid during that period at somewhere between 75,000 and 85,000. As well, the weight of early redemptions can be estimated as ranging between 2-3% of the outstanding balance, representing approximately 9-14 billion euros. Indeed, these estimates suggest that early cancellations are in the order of magnitude of around half of the amount invested in Treasury bills and mutual funds in the first half of the year, which too are on the rise, thus underlining the increasing preferences of savers to reduce outstanding debts.

While rate increases have clearly had significant implications for banks, they have also been key to underpinning the recent favourable performance of the insurance sector. In what looks to be the tail end of monetary policy tightening by central banks, the insurance business in Spain is staging spectacular growth in revenue (premiums), fuelled by life insurance products. Yield curve normalisation over the past year has created the conditions, previously absent, for renewed development of traditional life and savings products, having languished for many years against the backdrop of zero or negative rates. These products have also benefitted from the banks' strategy of keeping rates on their deposits low until now. With rates now looking more likely to stay high for longer, momentum in these products is expected to continue. While further tightening is not anticipated, the

slow reduction in inflation from current levels means the ECB is now expected to keep its benchmark rates at current levels until mid-next year, creating optimum conditions for business development in the life segment for the coming quarters. As a result, total annual premiums across all insurance businesses could hit a range of 75-80 billion euros in 2023 and 2024, which would mark growth of 15%-20% from 2022 levels. Moreover, business conditions look set to remain attractive for even longer, having left behind the era when interest rates of zero per cent thwarted any chance of growth. Nevertheless, from a broader perspective, the sector is likely to suffer, particularly in the non-life business, from the economic slowdown and high costs of claims in the motor insurance segment.

Lastly, but importantly, we examine how rate increases are affecting liabilities, namely, deposit remuneration. According to the Bank of Spain, rates on corporate deposit accounts increased from 0.03% in July 2022 to 0.46% in August 2023. Over that same timeframe, the average rate on term deposits from corporations increased from 0.60% to 2.67%. As for bank accounts for households, the rate offered on sight deposits increased from 0.01% to 0.12% during that period, increasing from 0.04% to 1.37% on term deposits. Assessing deposit pass through at the EU level, the European Central Bank's statistics reveal that remuneration on deposit accounts in Spain averaged 2.31% in August, compared to 3.03% on average in the eurozone. That gap is partly the result of a different financial reality for the Spanish financial institutions. The Spanish banks reinforced their liquidity buffers significantly in the wake of the financial crisis. Thus, their initial failure to pass the ECB rate increases on to deposit rates to a greater extent (a phenomenon we are witnessing at present) reflects, at least in part, the abundance of liquidity held by the Spanish banks that was provided by the ECB itself, curtailing the incentive to compete for deposits. That said, the deposit pass through already underway is set to intensify further in the coming months as the ECB continues to mop up liquidity, including through the unwinding of TLTROs.