Letter from the Editors

The international context is currently characterized by the impact of the monetary policy tightening cycle and uncertainty as a result of geopolitical tensions. The challenges caused by shipping disruptions in the Red Sea are once again raising concerns over supply chain disruptions and inflation. Indeed, they are already making freight rates considerably more expensive, particularly impacting the European economy. Another weakness for the global economy is the adjustment in China as a result of private debt overhang. While the situation in China is not new, the risks are perceived to be getting worse. By contrast, the US economy is remaining resilient to the impact of interest rate hikes thus far.

Broadly speaking, recent indicators reflect continued global sluggishness. As an example, the December purchasing managers' index (global PMI) was slightly above the threshold of 50, consistent with slow growth in the world economy. In the case of the eurozone, the indicator remains in a contractionary phase (of the four major European countries, only Spain is above the 50 threshold).

Within this context, in the January issue of *Spanish and International Economic & Financial Outlook (SEFO),* we first look at the recent agreement on Europe's new macropolicy framework and the implications for fiscal adjustment and monetary policy. The Spanish Presidency of the Council of the European Union (EU) announced the Council's agreement on a new framework for macroeconomic policy coordination on 21 December 2023. The agreement marks the culmination of a pan-European debate over macroeconomic policy and fiscal adjustment that started during the pandemic, as governments took stock of the role of macroeconomic policy coordination in shielding Europe's economies from the full impact of restrictive measures imposed to fight the spread of COVID-19. The new framework places emphasis on the need for national ownership over efforts at fiscal consolidation. It also builds on the recognition that the fiscal positions of member state governments are different from one country to the next. At the same time, it acknowledges that all EU member states should have incentives to invest in areas of common interest, including responding to climate change, fostering the digital and green transitions, and bolstering national defence. It also takes steps to simplify the design and the monitoring of fiscal consolidation measures to make them more credible and more transparent, which should bolster efforts to curtail macroeconomic imbalances and reduce unwanted volatility in financial markets.

Next, we examine some aspects of the Spanish economy – past and present. For instance, we take a look at the outlook for the Spanish economy over the medium-term in the context of uncertainty. Compared to its European peers, the Spanish economy has weathered the inflationary storm and geopolitical tensions of recent years relatively well, buoyed by its strong competitive positioning. GDP growth is estimated at 2.4% in 2023, which is nearly two whole points above the eurozone average, with the current account surplus hitting an all-time high. In the near-term, however, a slowdown is anticipated in light of the weak external environment and contractionary turn in macroeconomic policy – both fiscal and monetary. We are forecasting GDP growth of 1.5% in 2024, which is nevertheless above the projection for the European average. Elsewhere, investment in capital goods remains 8.8% below pre-pandemic levels, a trend that does not bode well for productivity in the medium-term and poses a challenge in terms of maximizing the impact of the European funds on the Spanish economy. Lastly, the public deficit is set to remain above the thresholds required by Brussels, even if growth recovers as expected in 2025.

We then take a step back and assess how Spanish households' income, savings and wealth has evolved over the 21st century. Spanish households and their finances have undergone major transformation since the start of the century, from the time of Spain's inclusion in the eurozone. Taking a dual macro and micro perspective, an analysis of Spanish households over time, as well as relative to those of other large eurozone economies, reveals various major structural changes as regards the composition of the universe of Spanish households, and the main trends with respect to their income, savings, and wealth over the period. Indeed, driven in part by immigration, the number of Spanish households has increased in absolute terms as well as relative to the rest of Europe, meanwhile their average size has contracted, albeit remaining larger than the eurozone average. In parallel, there has been a widening of the wealth gap with respect to Europe, accompanied by a widening of the generational wealth gap in Spain, with households with the oldest heads having seen their income increase. In contrast, an area where there has been little change is households' scant propensity to save, remaining low and highly volatile compared to the levels in other eurozone economies. Nevertheless, this has not prevented Spanish households from accumulating wealth on equivalent or higher levels relative to neighbouring countries, a trend plausibly explained by Spanish households' propensity to invest in the real estate market, and which is once again adding cost pressures for younger households. These changes should be taken into consideration to ensure proper public policy design.

As discussed in the previous article, investment in Spain's housing market has always been a relevant phenomenon for the country's economy and wealth formation, not just by Spanish households but also by non-residents and wholesale investors. We explore this issue up close in the next article which focuses on a current snapshot of Spain's housing and mortgage markets. Despite an adverse economic climate, house price growth is proving resilient in Spain, fuelled by wholesale and non-resident demand, in addition to retail, residential demand. Indeed, just 38.9% of house sales are completed with mortgages. Although the data do not enable comprehensive identification of the underlying reasons, a number of circumstantial factors may be affecting these metrics, including a higher incidence of mortgage-less purchases in touristic areas and in inland Spain, whether by foreign buyers or as second homes. At any rate, the clearest interpretation of this phenomenon is that overall market volumes are largely being shaped by investment transactions, which are driving up prices. As for mortgage activity, in the aftermath of the pandemic, volumes started to rise again, at year-on-year rates of around 1%. Since December 2022, however, volumes have been contracting, by 3.1% year-on-year in October 2023 , the last month for which this information is available. Spain has yet to find a point of equilibrium in the mortgage market between the heady rates of the financial and property bubble and those corresponding to a more normal monetary environment. These dynamics have eroded Spain's affordability metrics, particularly since the financial crisis and pandemic, when prices recovered swiftly, outpacing wage growth.

Factors such as inadequate long-term land policies and growth in demand have exacerbated the problem, increasing inequality between home-owners and those unable to get a foothold on the housing ladder. Focusing resources on enhancing access to affordable, quality housing, fostering an efficient rental market –without interventions that ultimately inflate rents– and increasing housing supply (including more public housing options) could help to curb this trend and facilitate more equitable access to housing.

We then shift our focus to the financial sector, exploring the situation of the market for contingent convertible bonds, or CoCos, which suffered a rout, but have since recovered. CoCos, which are additional tier 1 (AT1) instruments, have been the instrument of choice for European and Spanish banks looking to reinforce their capital since the financial crisis and, more importantly, the cornerstone of the bank resolution mechanism insofar as they constitute loss absorbing instruments in the event of resolution. As a result, the market for CoCos has emerged as a very important barometer, as or more important than the market for banks' shares, for measuring confidence in the banking system. That is why this market suffered a rout during the banking crisis of last March and was hit particularly hard by how the Swiss authorities treated Credit Suisse's CoCo creditors, creating "stigma" around the instrument in general. The way CoCos were bailed in when Credit Suisse was rescued created a stigma that prompted the global CoCo market to collapse. Nonetheless, the market has recovered in recent months, marked by a significant rebound in prices and, above all, in issuance activity.

The next section of this months' *SEFO* looks at bigger picture policy issues, such as industrial and competition policy, as well as monetary authorities' approach to climate policy in recent times. To being with, we analyze EU industrial policy and how it should factor in competition policy in order to achieve maximum benefits for the bloc. Economists have traditionally been skeptical over the use of industrial policy. However, tech progress, climate change and geopolitical tensions have once again placed industrial policy at the center of the political debate. Without taking a position in favor or against industrial policy, it is important to note that, if public sector intervention is indeed necessary, it should be done respecting competition policy and innovation, not least within the EU, where there is added pressure to execute NextGenEU. To achieve sustainable economic development and minimize negative impacts on the market, industrial policy should be limited to situations in which a market failure is identified and implemented through competitively neutral mechanisms, without discrimination regarding sectors, companies or technologies.

Given the importance of industry to European countries, and in particular Spain, we provide a comparative analysis of the investment in intangibles, a key variable underpinning competitiveness, within Spain compared to the rest of the EU. The EU and Spanish governments' strategic commitment to reindustrialisation, setting the target of having 20% of GDP come from manufacturing, requires increased competitiveness and, by extension, further progress on digital transformation. Digitalisation is underpinned by investment in intangible assets such as R&D, software, branding, design, employee training and organisational capital. In Spain, the intensity of the manufacturing sector's investment in intangible assets is practically half of the European average (10.7% *vs.* 20% of GVA), a worrying trait that is repeated all across the various areas of manufacturing activity. In addition, at least since the financial crisis of 2008, the gap in investment intensity separating Spain from the EU has widened. As a result, if the Spanish manufacturing industry is to gain competitiveness at the international level, it must commit strongly to digitalisation, which requires closing the gap in investment intensity in intangibles relative to its competitors. In that context, the NGEU funds, whose aims include digitalisation, with specific financing for several strategic investment plans within the industrial sector, are a major opportunity.

Finally, we close this issue with a recap of how the main central banks have been addressing climate change policy, looking at the differences across the approaches of the Fed, the ECB and the BoE, which could provide some insights into what we could expect from these institutions going forward. While it is widely acknowledged that climate policy-making is the prime responsibility of governments, central banks are also taking steps to address climate change within their remits. An examination of the integration of climate change considerations into the operations of the European Central Bank (ECB), the Bank of England (BoE), and the Federal Reserve (Fed) highlights that both the ECB and the BoE are more proactive than the Fed in their commitments and policy measures to tackle climate risks. Notably, the BoE has pioneered several initiatives in the last few years, while the ECB has recently made more significant advancements in other areas related to supervision and collateral rules. The extent to which central banks integrate climate risks into their work varies depending on each institution's respective mandate and domestic political preferences *vis-à-vis* climate change.