

Letter from the Editors

Global uncertainties, together with the continuation of armed conflicts in the Ukraine and Gaza, continue to weigh on international trade and force a complex transition of supply chain and energy models. Another factor complicating the global scenario has been the effect of monetary tightening. In both cases, the impact in the eurozone is more pronounced than in other advanced economies, particularly the US. Finally, the international environment is also suffering from China's adjustment following the bursting of the credit bubble, with spillover implications on domestic demand and international trade.

The differential impact of these shocks across blocs is reflected in the performance of economic indicators. The PMI business turnover index remains in contractionary territory within the eurozone, although a slight upturn is perceptible according to March data. Along these lines, in its March projections, the ECB cut its growth forecast for the eurozone to 0.6% (two tenths of a percentage point lower than in the December round). This context of weak demand has also led to a reduction in the inflation forecast to 2.3% (four tenths of a percentage point lower). By contrast, in the case of the US, the PMI indicator points to continued expansion in both the industry and services sectors. Finally, in China, the indicator is consistent with the persistence of a weak growth rate.

Within this context, the March issue of *Spanish and International Economic & Financial Outlook (SEFO)*, starts off with an assessment of the international economic backdrop, subsequently providing a deep dive into the recent evolution and existing challenges facing Spain's labour markets.

The global economy has demonstrated significant resilience in recent quarters. However, the economic backdrop remains highly uncertain, marked by key risks related to geopolitical tensions, financial stability, and fiscal-monetary policy mismatches. The good news is that we have dodged recession fears that loomed in the wake of the sharp increase in energy prices during the summer of 2022 and that inflation has been responding well to central banks' monetary policy tightening. The bad news is that the outlook for the medium-term is not too optimistic. For example, the IMF is forecasting global growth of 3.1% for the end of the decade — half a point below the medium-term estimate expected before the pandemic and nearly two points below the growth expected before the Global Financial Crisis of 2008, foreshadowing stagnation in potential output at current levels. Hopefully, the normalisation of the business cycle following the recent years of turbulence, and the major structural changes that are already underway (AI, demographic trends, *etc.*), could open the door to outperformance of these lacklustre forecasts.

Within this global context, in the next section of this month's *SEFO*, we examine the key trends and outlook for Spain's labour market. The performance of Spain's labour market has improved, closing in on European standards, likely a result of recent reforms and demographic changes. Nonetheless, the labour market remains one of the chief weaknesses of Spain's productive model. In the last five decades, the unemployment rate has only been in the single digits for a brief period of time before the onset of the financial crisis, fuelled by an unsustainable credit bubble. Moreover, Spanish unemployment has been higher than the rates observed across its European peers virtually non-stop since harmonised data exist. One of the main causes of this long-standing blight is excessively procyclical employment creation and destruction: traditionally, recessionary episodes have led to disproportionate job losses, which are hard to recover during periods of growth. In 2019, the number of people in work in Spain was still below the level observed before the financial crisis. That said, the labour market demonstrated better performance in the wake of the pandemic relative to earlier recessions. Shortcomings in placing job-seekers have been an aggravating factor. In Spain, it is not easy to come off the dole queue, a phenomenon that affects less-skilled workers and women looking to rejoin the labour force after time off to have children in particular. Hence the high rate of long-term unemployment. Lastly, the transition from education to work is challenging, as is borne out by a high rate of youth unemployment by European standards. Given the importance of addressing these challenges to maintaining employment growth and closing the social divide, it will be critical to tackle this sizeable but urgent issue, particularly in light of the pace of technological transformation, accelerated by the deployment of artificial intelligence.

In the next article, relatedly, we look at how the growth in job postings gives us clues as to the evolution of Spanish labour demand. Spain's labour demand has demonstrated resilience in the face of the pandemic, as job postings have sustained growth in line with their long-term

upward trajectory through February 2024, despite the more significant drop in hiring witnessed at the start of the pandemic compared to other countries. Spanish job postings were up 50% from February 2020 to February 2024. Analysis supports a positive correlation between job posting growth and wage growth: occupations for which job postings have risen more strongly have, on average, seen greater increases in advertised wages between 2019 and 2023. This suggests that at least a part of the recent acceleration in Spanish wage growth may be attributed to the surge in demand for new workers, with other factors, such as the bargaining power of workers and unions, particularly in the context of high inflation and minimum wage increases, likely also playing a significant role. Data from early 2024 indicate a decline in the total stock of job postings in Spain from their peak but the influx of new job postings has continued to rise, suggesting that many employers maintain optimism regarding the near-term economic outlook, as postings reflect hiring intentions. Moreover, job postings remain elevated, both in comparison to historical levels in Spain and current trends in other large European economies, where a gradual slowdown persists. These trends support a forecast for solid employment and GDP growth for Spain in 2024 relative to other advanced economies and serve as a key labour market indicator to monitor as the year unfolds.

As well, as regards Spanish employment trends, we examine the precarious situation of Spanish youth unemployment and how this links to housing affordability. In just over 15 years, Spanish youths have suffered the fallout from two economic crises that have hurt their current wellbeing as well as their expectations for the future. The fragility of the Spanish job market, characterised by a high incidence of temporary contracts and high structural unemployment, has taken a particularly heavy toll on the country's young people for whom job quality and employment rates have been significantly lower. This has led to an increased concentration of young people in major urban areas, migrating in search of work opportunities. However, in those cities

young people are facing more expensive housing, undermining their savings, and making it hard to buy a home, ultimately reducing their wealth. This problem has important repercussions for society as a whole related to increased pressure on the social security system due to lower birth rates, in addition to increases in income inequality and decreased aggregate demand with knock-on effects on the real economy. To revert this situation, it is vital to pursue evidence-based public policies that foster the creation of quality work, job stability and housing affordability, especially in the large cities where demand for housing for young people is concentrated. Such policies will be crucial to ensure Spain's youth can fully realise their full potential and contribute to the country's economic growth and collective wellbeing.

Having touched upon the topic of housing affordability, the next article analyses further the issue of Spanish rental markets. Residential rents have increased sharply over the past decade. Average household expenditure on rent increased by 27.7% between 2015 and 2022, which is well above the growth in average household income (16.6% in households with one earner and 22% in households with two or more earners). The situation got worse after the pandemic. Until 2020, around three of every 10 households earmarked over 30% of their total spending on rent. In the wake of the pandemic, that percentage has increased to approximately four out of every 10 households. In fact, in 2022, aggregate spending on rent plus utilities (water, energy and common services) accounted for over 30% of spending for 60.5% of tenants. Regionally, there are significant differences in the financial burden implied by renting, with Ceuta and Melilla, the Basque region, the Balearics, Madrid, and Catalonia registering the highest burdens. La Rioja, Murcia and Extremadura are home to the lowest burdens. The rent controls introduced in 2022 kept growth in average spending on rent at 2.1% (compared to 11.2% in 2019). As far as we are aware, there are no evidence-backed estimates of how the latest regulatory changes may have affected supply. However, the real estate portals estimate a reduction of close to 30%.

The subsequent section of *SEFO* shifts the focus over to the financial sector. We first start with an analysis of the most recent figures on Spanish banks' profitability. The Spanish banks reported sharp earnings growth in 2023, with the six largest banks recording over €26 billion in profits on aggregate, growth of 27% from 2022. Several relative indicators suggest that the increase in earnings is due to the recovery of some of the profit lost since before the pandemic, although this claim warrants caution. As well, it is also important to note that profitability is a broader concept than their bottom lines: the banks, like any other private corporations, are valued by the market and their shareholders. Indeed, the six largest banks are trading at an average price to book value of 0.78x. An analysis of the banks' share price performance taking a long-term perspective shows that the banking sector has come back — gradually — from very low levels of profitability to revisit pre-pandemic levels. This has sparked the debate about whether the Spanish banking sector should be subject to additional taxation. This situation has prompted a deep dive into the issue in an attempt to understand the role these earnings play not only in the stability and growth of the financial institutions themselves but also in the creation of general economic wellbeing. In addition to reinforcing the banks' capital reserves, which are essential to their solvency and ability to tackle adversity, bank profits can finance growth, investments and, ultimately, stimulate the real economy.

We then build on this topic to explore the link between recent banking sector performance and valuations. After two years of tailwinds, the Spanish and European banks' earnings have capitalised on the favourable interest rate climate, which has catapulted their margins while asset quality has kept the cost of risk at very low levels. By comparison with their outstanding earnings performance, the banks' stock market performance has been more nuanced. On the one hand, the banks have outperformed the general stock indices for the last two years. Nevertheless, they have yet to close the gap between their

market value and book value (the ratio known as price-to-book value, or P/B, remains at around 0.7x, implying a discount of 30%), despite the fact that their return on equity (ROE) is back above 10%, the threshold traditionally deemed necessary to close the valuation gap. Given the aforementioned correlation between the ROE and CoE implied by the P/B ratio, it can be deduced that the inability to close the gap can be attributed to one or both of the following factors: a) doubts about the banks' ability to sustain the current ROE levels; and/or, b) the cost of equity (CoE) required of the banks has increased above the conventionally assumed threshold of 10%. On the basis of the takeaway from the responses provided to the *Risk Assessment Questionnaire* carried out by the European Bank Authority (EBA) across a wide sample of European banks, the explanation appears to most likely lie primarily with the second factor. In any event, without questioning the banks' perception that their cost of equity has increased in the past year (attributable, to a degree, to an element of "stagnation" in long-term interest rates at high levels), the discount at which the European and Spanish banks are currently trading seems excessive considering that a good percentage of the banks surveyed see their ROEs as sustainable over the coming year.

Finally, we close this *SEFO* with perspectives on Spain's budgetary process. Delivery of the targeted deficit below 4% for 2023 is plausible, thanks to the healthy momentum in tax collection boosted by higher than expected growth in gross domestic product (GDP). At first glance, the anticipated outcome for 2023 appears favourable and in line with expectations, with last year's deficit around 1% of GDP lower than that of 2022. However, the result is less favourable if we take into consideration the scant adjustment in the structural deficit, which in 2023 will exceed headline deficit figures. Domestic political tensions first delayed the 2024 budget process, and ultimately resulted in the draft budget being pulled in order to begin preparing the 2025 budget. Despite a likely increase in tax revenues as a result of the upside in GDP growth

once again, there is no guarantee that Spain will escape the EU's Excessive Deficit Procedure in 2024, which, under the new rules, will continue to be activated in the event of a deficit over 3% of GDP. For this reason, fiscal decisions altering the 2023 extended budget in the next months should be compatible with a significant reduction of the structural deficit to advance toward compliance with the EU's deficit and debt targets.