Letter from the Editors

As the July issue of *Spanish and International Economic & Financial Outlook* (*SEFO*) goes to print, geopolitical and military conflicts persist, while protectionist tensions are intensifying, weighing on world trade in goods. European industry is the most affected, with manufacturing PMIs confirming signs of deceleration, remaining below 50 for the Eurozone as a whole as well as in each of the major European economies, except Spain. That said, services are performing better, particularly those most closely associated with tourism.

The lacklustre performance in Europe contrasts with relative strength in the US, both in services and industry. The resilience of growth, together with uncertainties about the pace of inflation de-escalation, have clouded the outlook for monetary policy easing by the Federal Reserve. Finally, in China, the deleveraging process continues to weigh on domestic demand, while encouraging companies to export to offset weakness in domestic markets.

Within this context, we start off the July *SEFO* with an update of our forecasts for the Spanish economy for 2024 and 2025.

The Spanish economy continues to post healthy growth, outpacing the European average by a considerable margin. We are forecasting GDP growth of 2.5% this year and of 1.8% in 2025, buoyed by the external surplus, private sector deleveraging and, to a lesser degree, the NGEU funds. As a result, we are expecting the creation of 730,000 new jobs over the next two years, which will nevertheless leave unemployment in the double digits. As for inflation, we are forecasting CPI of 3.3% in 2024, just 0.2pp below the 2023 figure. This inertia, which is typical of inflationary episodes, reflects the reversal of VAT and excise duty cuts on energy products (introduced in the wake of the invasion of Ukraine), wage agreements for restoring purchasing power and weak productivity trends. Disinflation should become more tangible in 2025, although we are still forecasting CPI above the ECB's target of 2%, in both Spain and the rest of the Eurozone. Despite recent economic successes, corporate investment and investment in housing continue to lag pre-pandemic levels, undermining potential output. Lastly, the persistence of such a high structural public deficit leaves the Spanish economy vulnerable to geopolitical and financial risks.

Relatedly, we next take a look at a crucial issue for the Spanish economy, yet one that is difficult to accurately measure-the informal economy.

Analysis appears to support a favourable evolution of the tax revenue-to-GDP figures and the estimates regarding the size of the shadow economy in Spain. The shock

induced by the pandemic led to a spike in inflation, which drove growth in tax receipts to a level that apparently outpaced inflation and real economic growth, albeit the evidence is far from conclusive. The gap in the tax burden with respect to the EU-27 average in 2019 has closed by half. This gap originated from a plethora of special tax treatments and a relatively larger shadow economy and level of tax fraud. Related to tax fraud, indeed, it is possible that the rise in electronic payments during and after the pandemic (perpetuated by the decrease in cash payments during this period) has made tax evasion more difficult, helping to increase VAT collections and changing individuals' behaviour. As well, the pandemic may have helped bring about a decrease in the number of workers without a contract and not paying income taxes and social contributions. Thus, given that the regime for special tax treatment has not changed substantially, it has been deduced that resolution of the latter issues is responsible for reducing the gap. That said, once again, on this point, the empirical evidence is far from conclusive. Moreover, the surprising and starkly contrasting pictures painted by the various calculations made using VAT, and the divergence in estimates about the size of the shadow economy, which place Spain both above and below the EU-27 average, clearly illustrate the need for more rigorous analysis over a larger time series after the pandemic. Such an effort would additionally serve to provide the foundations for building a more ambitious strategy for situating Spain within the first quartile of the EU-27's best-performing member states in terms of efforts to combat the shadow economy and tax fraud.

Moving on to the financial sector, we assess the various impacts of interest rate changes - first more broadly, and then through a more targeted lens as regards Spanish banks' margins, in addition to the performance of the Spanish insurance sector.

In June 2024, the ECB cut the rate on its main refinancing operations by a quarter of a point to 4.25%, convinced by the let-up in inflationary pressures and drop in core inflation. 12-month Euribor has been trading between 3.4% and 3.9%, reflecting market expectations about future rate cuts by the ECB. However, the effects of the rate cut have been minor as the credit channel remains relatively rigid. The volume of financing extended to the non-financial sector has been trending lower in 2023 and 2024, with credit contracting over this timeframe. For now, even in the face of the more favourable financing conditions, it is not likely that demand for credit will increase significantly in the coming months. Despite the rate tightening, the ECB's liquidity policy continues to play a crucial role. Even though the ECB has pared back its long-term refinancing operations, it continues to operate its asset purchase programmes, providing the market with stability but also prolonging dependence on official funding – although the tapering of its long–term financing programmes could increase financial volatility. In contrast, the Fed left its target range for the federal funds rate at 5.25-5.50%, evidencing its conservative approach to inflationary risks. The divergent decisions reflect different attitudes towards inflation, with potential implications for the global economy. In any event, the bond markets have responded to the ECB's move with a reduction in yields, while the equity markets have been mixed, reflecting uncertainty around the effectiveness of these measures. Going forward, clear central bank communication strategies remain key to mitigating market volatility and strengthening economic stability in an increasingly complex environment.

The two years since the start of rate tightening have been marked by very positive net interest margin dynamics in the European banking sector in general and in the Spanish sector in particular. Within this context, various factors have shaped the trend in margins, with some making a clearly positive contribution compared to others that have been less favourable and have even called into question the sustainability of current margins. Broadly speaking, the return on interest-bearing assets has been boosted significantly by the rate

effect, compared to a neutral or even negative volume effect, in line with meagre growth in credit, especially in Spain. As regards the cost of deposits, this has been shaped by a different strategy pursued by the Spanish banks compared to their European peers as a whole. This liability price management strategy has contributed to a different pattern in funding inflows and outflows and significant reconfiguration of the banks' pool of funding, marked by a bigger share of wholesale funding, particularly during the past year, when the banks have taken advantage of sharp tightening in their bond spreads. A disaggregation of the rate, volume and funding reconfiguration effects help to explain the incremental growth in the Spanish banks' net interest margin relative to their European counterparts.

As was expected in response to the extraordinarily rapid and intense period of interest rate hikes throughout 2023 in the midst of rampant inflation, last year's unique performance marked a turning point for certain lines of the Spanish insurance business. Indeed, the more than 76 billion euros of premium revenues recorded by the Spanish insurance sector in 2023 marks a new record. That sharp top-line growth – 18% from 2022 – was driven mainly by the life insurance business. Turning to the nonlife business, growth in premium revenues remained remarkably solid, the highest in recent years, at close to 7%. This noteworthy growth was driven by business growth in real terms but probably more so by the revaluation of policy premiums as a result of the adverse impact of inflation, which had been weighing on the business since 2022. However, a softer than expected economic landing, coupled with the containment of inflationary pressures, paving the way for a period of rate cuts, foreshadow a new scenario for the business in the quarters to come. Nevertheless, under the new scenario, if Spain's relatively favourable economic forecasts are on target, we would be looking at a new record in premium revenues for the sector of over 80 billion euros in 2024. This means sector conditions and prospects remain largely bright for the insurance sector as a whole, allowing for a robust outlook and the continued sizeable contribution to banks' profits.

Finally, we close this *SEFO* by assessing two microeconomic issues – competition and connectivity improvements in Spain's broadband network and the impact of higher levels of inclusion of women on the boards of Spanish companies as well as in executive positions at Spanish corporations.

Spain has experienced an increase in connectivity over the past decade, positioning itself as one of the leading countries in the European Union. Public support through broadband deployment subsidies has positively contributed to this evolution. Between 2013 and 2020, broadband deployment support programs in Spain mobilized a total investment of 672 million euros, with public support accounting for 51% of this total. Spain's competition authority, the CNMC, conducted a quantitative study of these subsidies between 2013 and 2020, which concluded that they have been effective in improving connectivity and creating positive competition synergies by increasing the variety of operators. Indeed, in 2020, nearly 4,000 municipalities out of more than the 8,000 existing municipalities had an active connexion to fiber optic networks (FTTH), constituting an enormous improvement compared to 2013, where only 270 municipalities (the most populated) had FTTH. Similar improvement is found from the perspective of concentration, considering that the number of municipalities with FTTH connections and a single operator decreased from 87% to 9% between 2013 and 2020. The improvements are most notable in smaller municipalities, with populations of fewer than 10,000 inhabitants, suggesting that public efforts should focus on fostering broadband deployment improvements in these types of municipalities.

Historically, corporate boards were predominantly male due to societal norms and systemic barriers limiting women's participation in senior leadership. More recently, institutional changes, such as board quotas and evolving

social norms, now promote gender diversity in boardrooms. Such changes are believed to have positively impacted ESG outcomes within firms. Through an examination of annual reports across Spain's IBEX-35 companies over the six-year period from 2017-2022, preliminary findings reveal that the overall impact of the presence of women directors and executives is limited except as regards sensitivity related to ESG issues, although the causality between gender diversity and ESG sensitivity cannot be confirmed. That said, the presence of woman directors is often linked to sustainability committees, providing diverse perspectives that improve the social and environmental responsibility of the companies. In the case of women executives, they seem to have a stronger impact on gender agendas.