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Quarterly report and macroeconomic projections for the Spanish economy. March 2023

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EDITORIAL

Editorial

Global economic activity weakened in the final stretch of 2022, although by less than expected. This loss of momentum was essentially a result of the persistence of high inflation and the consequent tightening of monetary policies and global financial conditions. Nonetheless, the falloff in activity was generally less pronounced than had been anticipated by most analysts' forecasts. Among other factors, the easing of bottlenecks in global production chains and the various measures taken by the public authorities to mitigate the effects of the inflationary surge and the energy crisis on the incomes and the consumption and investment decisions of private agents appear to have contributed to this greater resilience.

Moreover, the favourable developments in energy commodity markets (in particular, in the gas market) have helped to check the economic slowdown in recent months, especially in Europe. The rise in the price of gas and the deterioration in the security of supply of this commodity played a very important part in the worsening of the European economic outlook following the outbreak of war in Ukraine. However, in recent months this negative supply shock has been reversed more sharply than expected. In particular, largely as a result of the measures taken to discourage consumption and diversify supply, and of the mild early winter temperatures, gas prices have recently fallen below their pre-war levels and the risks of supply cuts in some of the main European economies have abated considerably.

In the first few months of 2023, there appears to be evidence of incipient improvement in the global economic environment. The signs of resilience exhibited by global economic activity in late 2022, the change in trend of many confidence indicators and the fact that China's abandonment of its zero-COVID policy appears to have had only a relatively transitory negative impact on its economy are some of the factors that have led many analysts to raise their growth forecasts for 2023 Q1 and for the year as a whole.

Also, some signs are discernible of inflationary pressures easing, although they have tended to be confined to the energy price component. In fact, generally, both food and the underlying component continue to display high inflation rates, which, in some cases, are still accelerating.

In comparison with these relatively positive developments, the appearance, following the closing date for this report,[1] of an episode of severe financial tensions at global level has brought about a new adverse shock of uncertain magnitude and persistence. This turbulence arose as a result of the deterioration in the financial position of a particular US bank with a very specific balance sheet structure, which made it particularly vulnerable to rising interest rates. Nonetheless, the fragility of this bank has generated doubts on international capital markets as to

1 The cut-off date for this report is 2 March 2023.

the soundness of other financial institutions. All this has occurred against a background in which interest rates have, in historical terms, been rising very sharply and rapidly across the world in recent quarters. As a result of these doubts, a large majority of the world's banks have recently experienced a significant decline in their stock market valuations and some of them (in the United States and in Switzerland) have required specific support from the authorities. There is currently no way of knowing whether, in the immediate future, these financial tensions will persist or whether they will gradually diminish. In any event, it seems likely that the uncertainty that has been generated will have some adverse impact on economic activity in the coming quarters and will also help to weaken the inflationary dynamics.

In such an uncertain context, at its meeting on 16 March, the European Central Bank's (ECB) Governing Council decided to increase its key policy interest rates by 50 basis points (bp), in line with its determination to ensure the timely return of inflation to the 2% medium-term target. Moreover, the Governing Council stressed how the elevated level of uncertainty (to which the recent global financial tensions have contributed) reinforces the importance of a data-dependent approach to its future monetary policy decisions, based on its assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the strength of monetary policy transmission, in particular.

The ECB's Governing Council stressed that the euro area banking system is highly resilient, with sound capital and liquidity positions. It also announced that it will closely monitor financial market tensions and that it stands ready to respond as necessary to preserve both price stability and financial stability in the euro area. The ECB's policy toolkit is fully equipped to provide liquidity support to the euro area financial system if needed and to preserve the smooth transmission of monetary policy.

In the first quarter of the year, the Spanish economy appears to have maintained a similar rate of momentum as in the second half of 2022. In 2022 Q4, GDP grew by 0.2%, against a background of notably weaker domestic demand, reflected, in turn, in a decline in imports. In early 2023, the favourable performance of social security registrations and the improvement in confidence indicators, among other factors, suggest that the rate of output growth may have increased slightly, to 0.3%. This would be consistent with the persistence of a certain degree of weakness in the macro-financial dynamics of the Spanish economy, in line with the information from the latest edition of the Banco de España Business Activity Survey (EBAE).[2] In particular, spending by Spanish households and businesses continues to be constrained by two important headwinds: persistently high inflation rates and rising interest rates.

Consumer price inflation has eased significantly in Spain since the highs recorded in the summer, although this has been almost exclusively attributable to the energy component. Indeed, as a result of energy prices moderating in Spain (to a greater degree than for other

2 Mario Izquierdo. (2023). "Encuesta a las empresas españolas sobre la evolución de su actividad: primer trimestre de 2023". *Boletín Económico - Banco de España,* 1/2023, 21. https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/23/T1/Fich/be2301-art21.pdf

European countries owing to the specific features of the Spanish electricity price-setting mechanism), year-on-year rates for this component have recently turned negative. However, the price of food – which makes up a particularly large share of lower-income households' consumption basket – has continued to accelerate, and underlying inflation has only eased very modestly to date. This downward stickiness of inflation in non-energy industrial goods and in services probably reflects the fact that the energy cost increases were passed through to final prices with something of a lag (as is also suggested by the Banco de España's Business Activity Survey), and, perhaps, the existence of asymmetries in the pass-through of these cost increases and the recent decreases.

The macroeconomic projections presented in the final section of this report (completed in early March, before the recent turmoil on the international financial markets) envisage a gradual strengthening in Spanish economic activity over the coming quarters. Contributing to the faster pace of output growth will be, among other factors, the expected reduction in inflationary pressures, a stronger international setting (driven in part by the reopening of the Chinese economy and the easing of global supply chain bottlenecks) and the launch of a growing number of investment projects under the Recovery and Resilience Facility of the Next Generation EU (NGEU) programme. At any rate, in terms of annual average growth, the favourable impact of these dynamics on activity will be especially visible in 2024 and 2025, when GDP will grow by 2.3% and 2.1%, respectively. In 2023, however, Spanish GDP will post growth of 1.6%, significantly below the 5.5% recorded in 2022, on account of the notable slowdown in Spanish economic activity in the second half of last year.

The projections also envisage a gradual easing of the current high inflationary pressures. In annual average terms, headline inflation will fall from 8.3% in 2022 to 3.7% in 2023, mainly on account of the negative base effects in the energy component and the expected decreases in energy commodity prices over the coming months, based on current futures market prices. However, when the main measures deployed by the authorities to mitigate the effects of the energy crisis expire, the acceleration in the energy component will lead to a much more modest decline in headline inflation, to 3.6%, in 2024, before it falls once again to 1.8% in 2025. Meanwhile, underlying inflation is expected to ease more slowly than headline inflation over the projection horizon, and is actually projected to rise from 3.8% in 2022 to 3.9% in 2023, before slowing to 2.2% in 2024 and 1.8% in 2025.

Against a backdrop of very high uncertainty, which has been exacerbated by the recent global financial tensions, the risks to these projections are tilted to the downside in the case of economic activity and appear to be balanced in the case of inflation. The main risk (to the downside in the case of activity and to the upside in that of inflation) continues to be linked to the possible geopolitical developments of the war in Ukraine, should it prompt further supply disruptions similar to those experienced in much of 2022. One risk that was already significant at the projection cut-off date and has since become more prominent is the possibility of further financial market turmoil. This would have downward effects on activity and prices, through two channels: an erosion of economic agents' confidence and a sharper tightening of financial conditions than currently anticipated. However, as mentioned above, a hypothetical swifter pass-through of the recent decreases in energy prices to other consumer prices in Spain and the rest of the euro area would be conducive to lower inflation and a greater rise in domestic demand, by bolstering real incomes and reducing the need for further monetary policy tightening. Conversely, while the risks of the current inflationary episode becoming more persistent have lessened, the possibility of feedback loops between wage and price increases cannot yet be ruled out. Lastly, on the external front, the effects of the reopening of the Chinese economy on global activity and inflation are uncertain.

REPORT

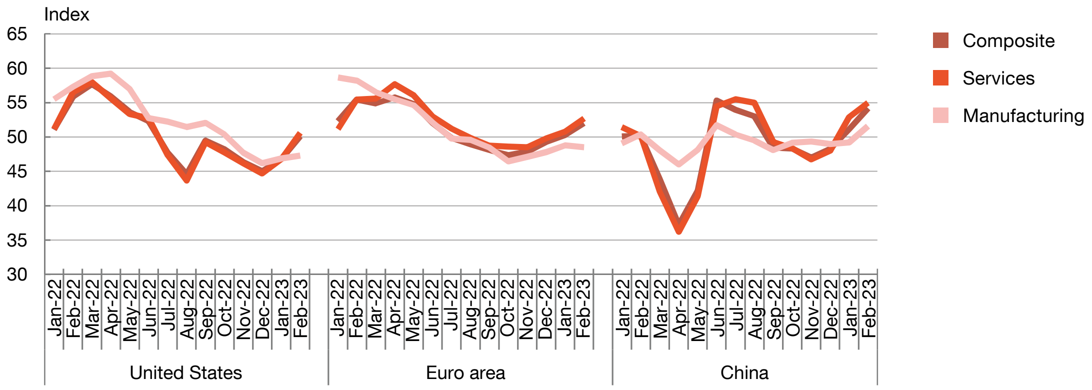
1 Global economic outlook for 2023 slightly less gloomy

— Global economic activity continued to slow down in the final months of 2022. This was particularly visible in global trade. However, the deceleration was less steep than expected a few months ago, partly as a result of energy prices surprising on the downside, global supply chain bottlenecks continuing to improve and a change in trend in the main confidence indicators (see Chart 1.a).

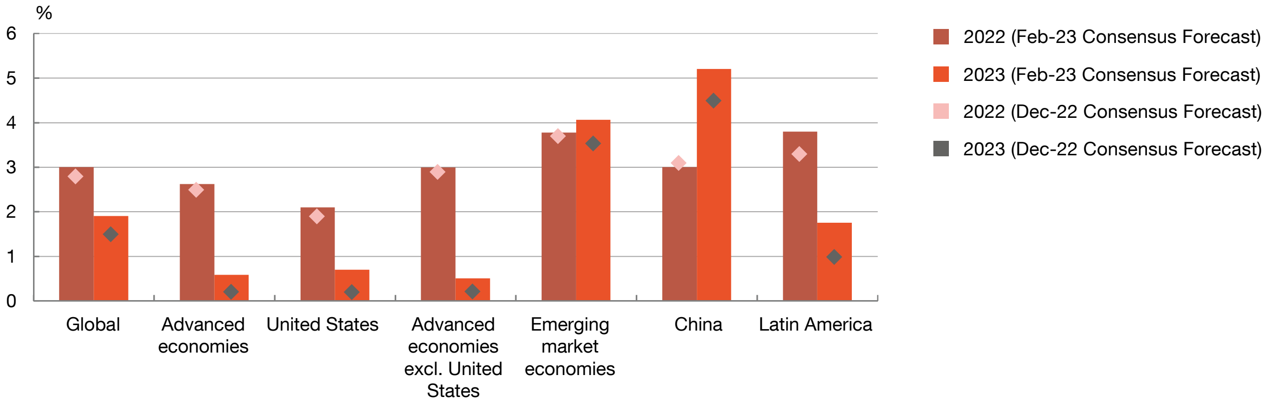
— These favourable dynamics continuing in early 2023, together with the reopening of the Chinese economy after it abandoned its zero-COVID policy – which only weighed on economic activity in China temporarily –, has led most analysts (including the International Monetary Fund and the European Commission) to revise up their growth projections for 2023, especially in the United States and China (see Chart 1.b). Even so, global economic growth is still expected to slow down significantly compared with 2022. The deceleration is projected to be particularly sharp in the advanced economies.

Chart 1

1.a Purchasing Managers' Indices



1.b GDP growth forecasts, by geographical area (a)



SOURCES: Consensus Forecasts and S&P Global.

a "Advanced economies" comprises 13 geographical areas: Canada, Czech Republic, Denmark, euro area, Iceland, Israel, Japan, Norway, South Korea, Sweden, Switzerland, United Kingdom and United States. "Emerging market economies" comprises 13 economies from Asia, eastern Europe and Latin America: China, India, Indonesia, Malaysia, Thailand, Hungary, Poland, Russia, Brazil, Chile, Colombia, Mexico and Peru.

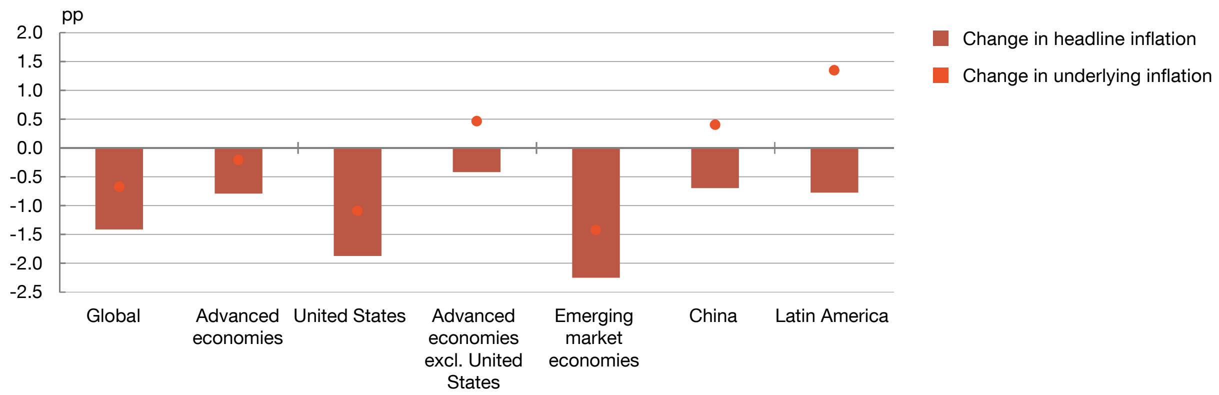
2 Headline inflation has moderated in the world’s main economies, essentially on account of lower energy commodity prices

— Headline inflation has fallen globally in recent months, mainly because of energy commodity prices easing and supply chain bottlenecks gradually improving. However, this slowdown in headline inflation – which remains at high rates – has barely passed through to underlying inflation (see Chart 2.a).

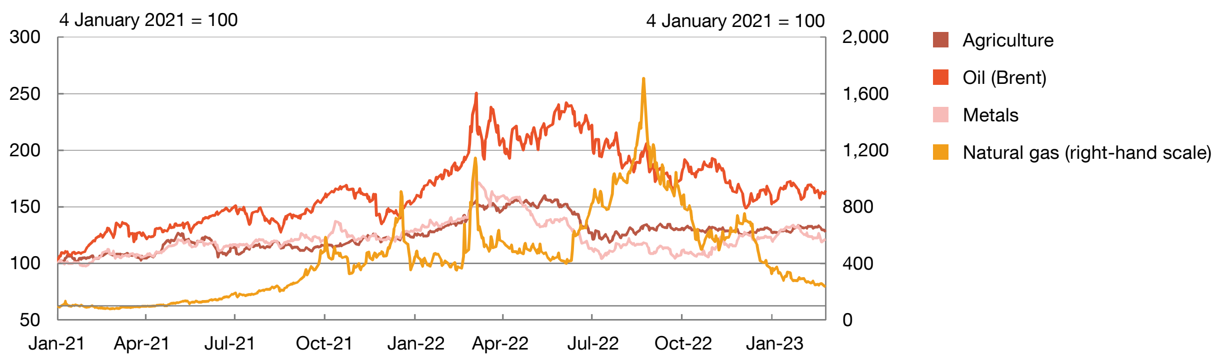
— On European commodity markets, the price of natural gas has fallen significantly in recent months, due partly to a particularly mild winter, lower consumption and the diversification of supply sources (see Chart 2.b). Oil prices have also decreased in this period, although less than natural gas prices. Meanwhile, metal prices have risen in recent months – essentially as a result of the improved growth outlook for China, whose economy accounts for a high share of global demand for these inputs –, albeit relatively moderately.

Chart 2

2.a Change in headline and underlying inflation between September 2022 and January 2023 (a)



2.b Commodity prices



SOURCES: National statistics and Refinitiv.

a "Global" comprises China, Czech Republic, euro area, Hong Kong, Hungary, India, Indonesia, Japan, Malaysia, Russia, Singapore, South Korea, Taiwan, Thailand, Turkey, United Kingdom and United States, as well as "Latin America" (comprising Brazil, Chile, Colombia, Mexico and Peru). "Advanced economies" comprises Canada, euro area, Japan, Norway, Sweden, Switzerland, United Kingdom and United States.

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3 China abandoning the zero-COVID policy will boost its economic growth in 2023 and could impact global inflation in different ways

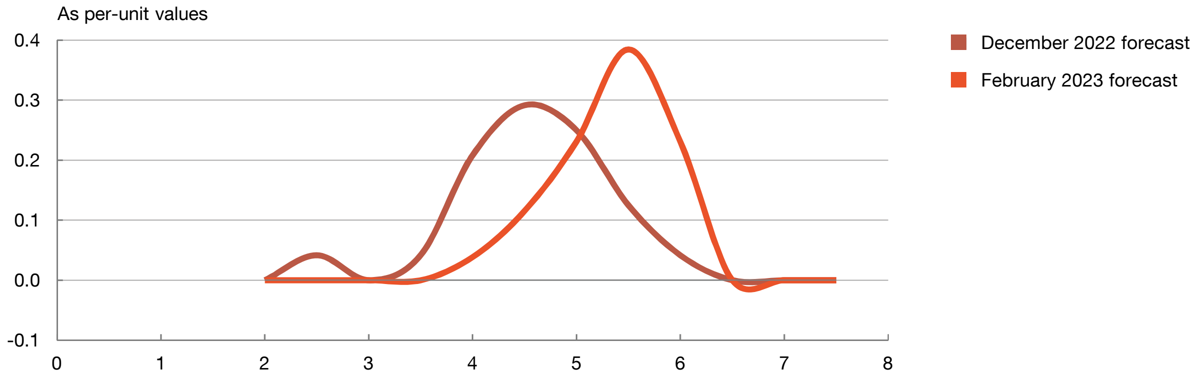
— The Chinese authorities abandoned zero-COVID in early December 2022. This translated into a surge in infections and steep drops in mobility, prompting some production chain disruptions and a downturn in activity.

— However, the latest data point to a swift improvement both in the epidemiological situation and in mobility and economic activity in recent weeks. In light of these dynamics, the growth forecast for China in 2023 has recently been revised upwards significantly (see Chart 3.a). Meanwhile, projected inflation has also been revised up, albeit more moderately.

— The impact of the reopening of the Chinese economy on global inflation is one of the main sources of uncertainty at the present juncture. On the one hand, higher growth in China would boost global demand, especially for commodities, which would tend to drive inflation rates up. On the other, China's reopening may quicken the disappearance of the global production chain bottlenecks and strengthen the capacity of global supply to meet demand, which would partially ease the current high inflationary pressures. Which of the two channels will dominate and by what margin is, for the time being, highly uncertain and will depend, among other factors, on the breakdown of the economic recovery in China itself.

Chart 3

3.a Density function of the Consensus Forecasts for Chinese GDP in 2023 (a)



SOURCES: Consensus Forecasts and Banco de España.

a The density function was estimated by calculating the proportion of the forecasts standing within a certain range, considering intervals of 0.5 pp.

4 The world's main central banks continue to tighten their monetary policies

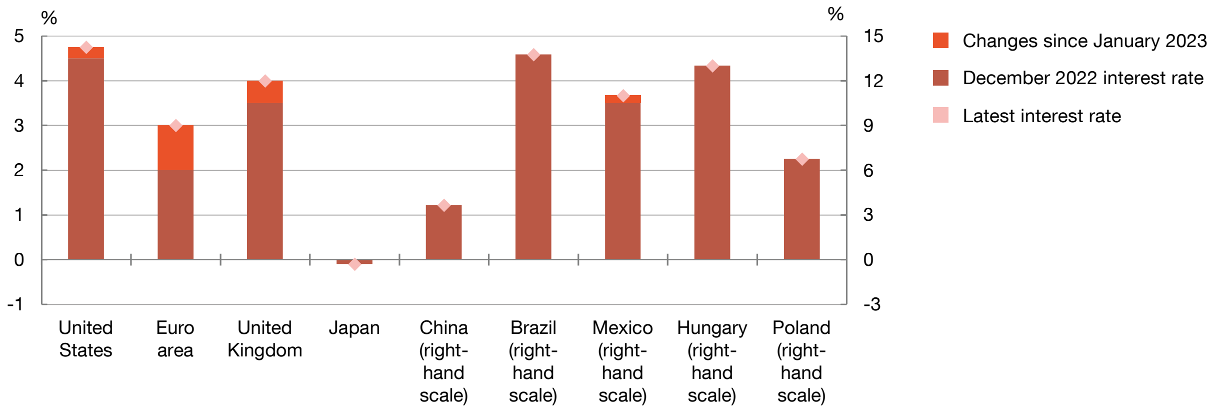
— In response to the high inflationary pressures, the central banks of the main developed economies have continued to raise their policy interest rates in early 2023. However, in some cases, they have reduced the pace of interest rate hikes compared with the last round carried out in 2022 (see Chart 4.a).

— For instance, the European Central Bank (ECB) raised its key interest rates by 50 basis points (bp) at its February and March meetings, taking the deposit facility rate to 3%. The Federal Reserve Board decreased the size of its hikes – compared with the last increases of 2022 – to 25 bp in February and raised its target range to 4.50-4.75%, while the Bank of England raised the Bank Rate by 50 bp, to 4%, in February.

— In the emerging market economies – which had launched their monetary tightening cycle before the advanced economies –, policy interest rates have not undergone significant changes in recent months.

Chart 4

4.a Policy interest rates



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SOURCES: National central banks and Refinitiv.

5 International financial markets have been conditioned by inflation developments, more-resilient-than-expected activity and, more recently, the uncertainty over the situation of some banks globally

— In recent months, and in response to the different price and activity indicators that have been published, there has been a gradual shift in expectations for how quickly the world's main central banks will tighten monetary policy in the future. In this respect, as a result of a less pronounced slowdown in activity than had been expected and more persistent underlying inflationary pressures, in early March the expectations were for sharper and longer-lasting monetary policy tightening than anticipated at the start of the year. However, over the last few days these expectations have partially reversed due to the uptick in risk aversion and volatility prompted by the recent financial tensions in the international banking sector.

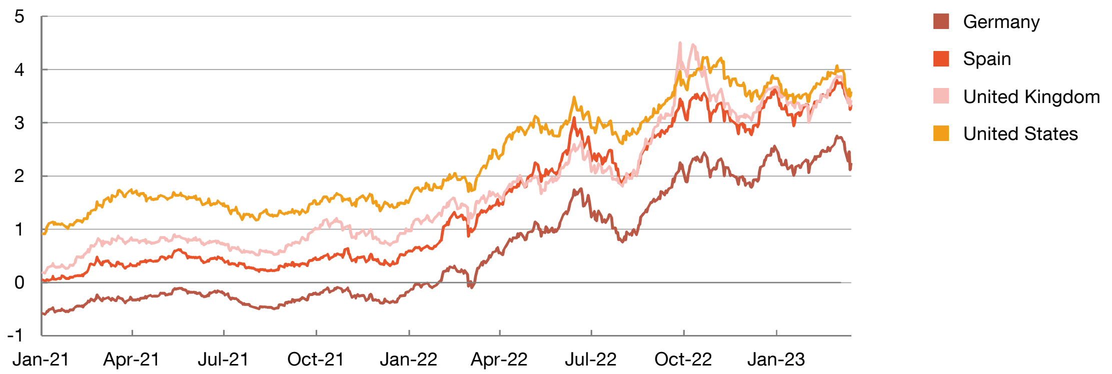
— As a result of the recent correction on the financial markets, at the cut-off date of this report, higher-rated long-term sovereign bond yields stood below their end-2022 levels (see Chart 5.a). Meanwhile, since end-December, the yield spread between European and German long-term sovereign bonds has scarcely changed for Greece and Spain, but has narrowed for Italy and Portugal (by 22 bp and 9 bp, respectively).

— Despite being adversely affected by the changes in monetary policy expectations since February and by the uncertainty surrounding the banking sector in March, most of the main global stock market indices have recorded gains in the quarter.

— In the foreign exchange market, the euro has depreciated slightly against the US dollar. For its part, the nominal effective exchange rate of the euro, defined as the weighted average of the bilateral euro exchange rates against the currencies of the euro area's trading partners, stands close to end-2022 levels.

Chart 5

5.a 10-year sovereign bond yields



SOURCE: Refinitiv Datastream.

6 In the euro area, the strength of activity has surprised on the upside in recent months, which has prompted an upward revision to the growth forecasts for 2023…

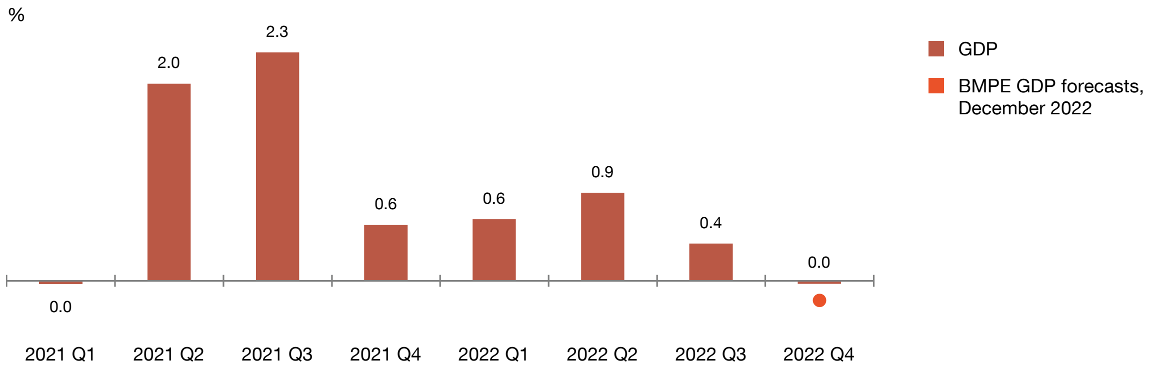
— GDP growth continued to decelerate in the euro area in 2022 Q4, essentially as a result of weak domestic demand and consumption, although the expected contraction in activity failed to materialise (see Chart 6.a).

— This positive surprise, along with the favourable developments in energy prices and various activity indicators – among others, confidence indicators – in early 2023, has meant that most analysts have recently revised up their GDP growth forecasts for the euro area in 2023 (see Chart 6.b). For instance, in the ECB's March projection exercise, euro area GDP is expected to grow by 1% in 2023, significantly more than the 0.5% envisaged in the December exercise.

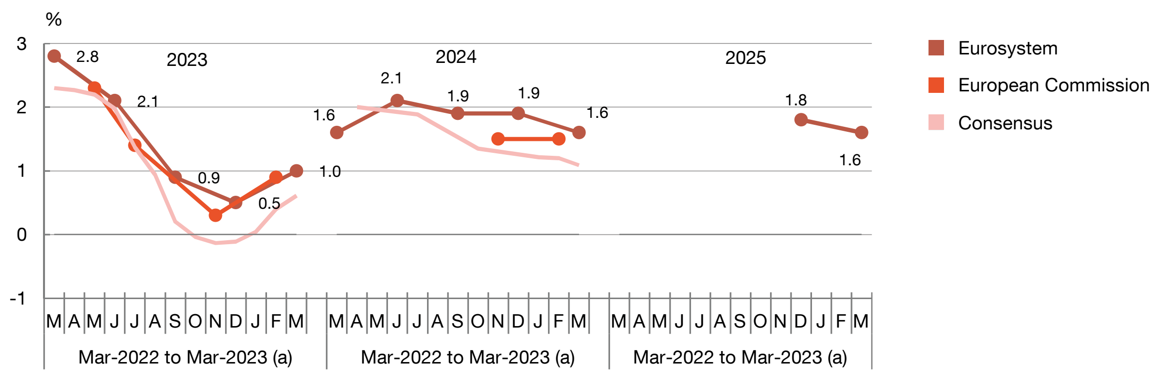
— By contrast, GDP growth in 2024 and 2025 could be somewhat weaker than projected in December (increasing by 1.6% in both years), owing in particular to a sharper tightening of financial conditions than was expected at that time, as a result of a tighter monetary policy stance.

Chart 6

6.a Euro area GDP growth path (quarterly rate of change)



6.b Euro area GDP growth forecasts



SOURCES: European Commission, Consensus Economics, Eurosystem and Eurostat.

a The letters refer to the months when the respective forecasts were published.

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7 … in a setting in which headline inflation has eased, on the back of lower energy prices, while underlying and food inflation both remain high

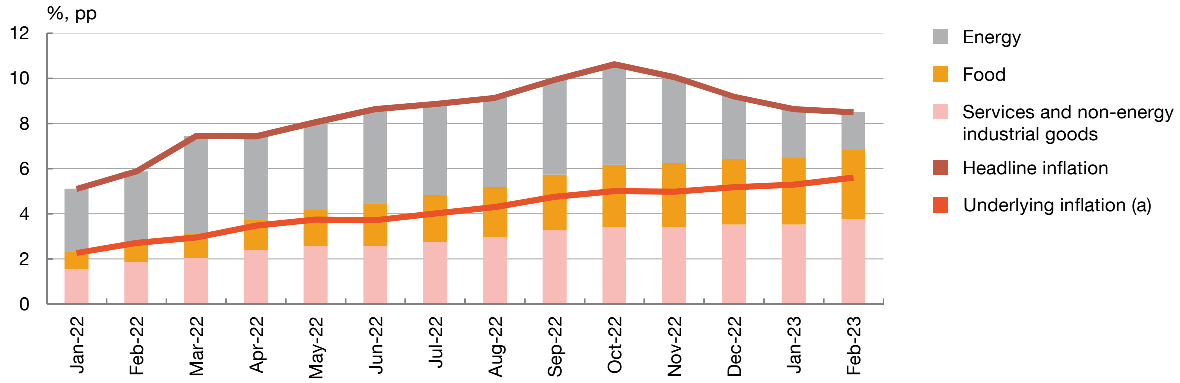
— Euro area inflation stood at 8.5% in February. This was lower than forecast and 2 percentage points (pp) off its October 2022 peak of 10.6%. This correction was underpinned exclusively by energy prices, as both underlying and food inflation continued to climb, with growth rates of 5.6% and 15%, respectively, in February (see Chart 7.a).

— Having incorporated these latest trends into its March projection exercise, together, among other factors, with the expected developments for energy prices and financial conditions (with the former expected to be lower and the latter to be somewhat tighter than in the December exercise), the ECB has revised down its baseline scenario for headline inflation over the whole projection horizon. In particular, average inflation rates are expected to reach 5.5% in 2023, 2.9% in 2024 and 2.1% in 2025, 1 pp, 0.5 pp and 0.2 pp, respectively, below the December forecasts (see Chart 7.b).

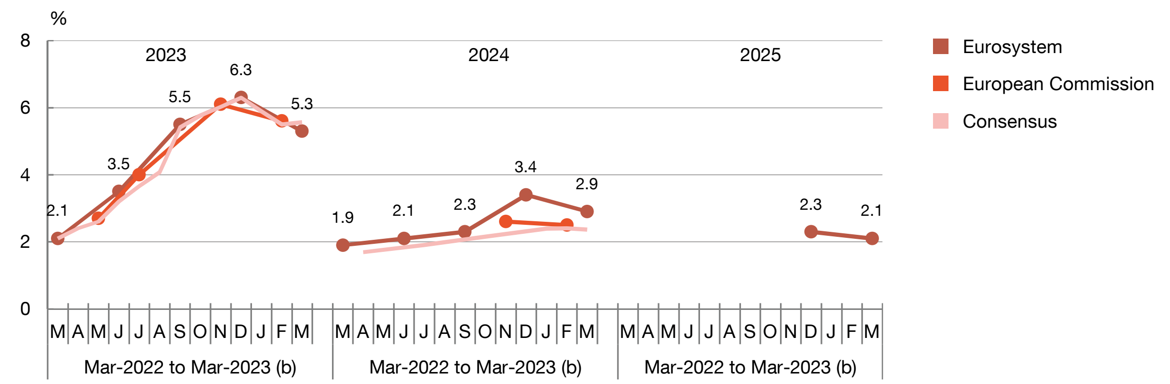
— In any event, the ECB's March projection exercise continues to point to what are still very high inflationary pressures in the underlying component. Specifically, the average underlying inflation rate is expected to climb to 4.6% in 2023 (from 3.9% recorded in 2022), before falling to 2.5% in 2024 and to 2.3% in 2025.

Chart 7

7.a Euro area inflation and contribution of components



7.b Euro area inflation forecasts



SOURCES: European Commission, Consensus Economics, Eurosystem and Eurostat.

a Headline HICP excluding energy and food.
b The letters refer to the months when the respective forecasts were published.

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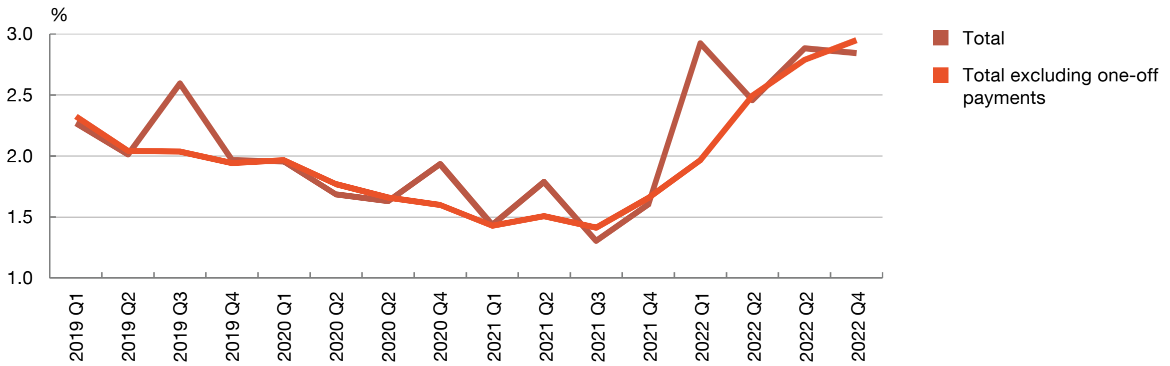
8 The uncertainty surrounding the euro area growth and inflation projections remains very high

— Among the main risk factors, the first is the uncertain course of the war in Ukraine and its implications for uncertainty and for commodity supplies and prices. The second is the recent financial market stress, which could further tighten global financial conditions and affect agents' confidence. There is also considerable uncertainty surrounding the implications for activity and inflation worldwide as a result of the reopening of the Chinese economy.

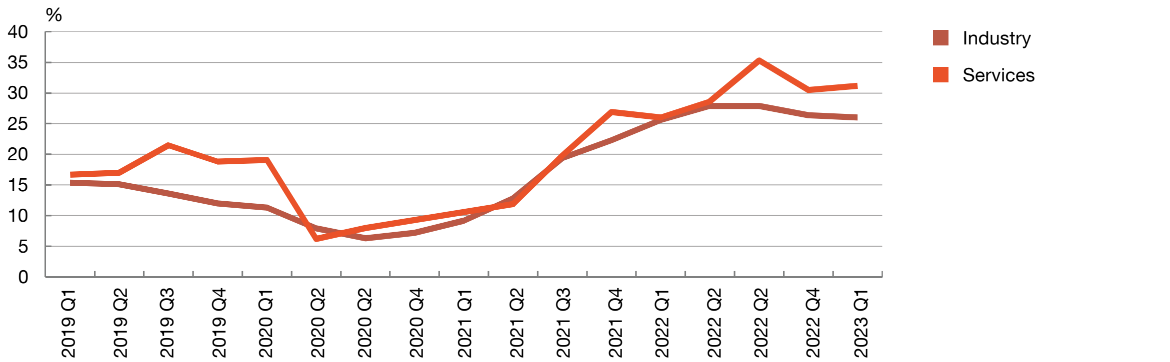
— On the domestic front, the recent upside surprises in underlying price inflation have fuelled doubts as to the persistence of inflation, in a setting in which higher costs may not yet have fully passed through to consumer prices. This is countered by the disinflationary effects of the recent fall in some commodity prices. But the risks of second-round effects on inflation have not been dispelled. In this respect, wage increases could be higher than expected, given the relative strength of the labour market (see Charts 8.a and 8.b).

Chart 8

8.a Euro area wage settlements. Year-on-year rates of change



8.b Euro area tight labour market conditions, by sector (a)



SOURCES: ECB and European Commission.

a Percentage of firms for which labour is a production constraint.

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9 The ECB has continued to raise its key interest rates and has emphasised that it stands ready to respond as necessary to preserve price stability and financial stability in the euro area

— Continuing with its monetary policy tightening, at its March meeting the ECB's Governing Council raised its key interest rates by 50 bp, taking the deposit facility rate to 3%. This is a cumulative increase of 350 bp since July 2022 (see Chart 9.a).

— Given the high level of uncertainty, future interest rate decisions will be data dependent and will be determined by the Governing Council's assessment of the inflation outlook in light of the new economic and financial data, the dynamics of underlying inflation and the strength of monetary policy transmission.

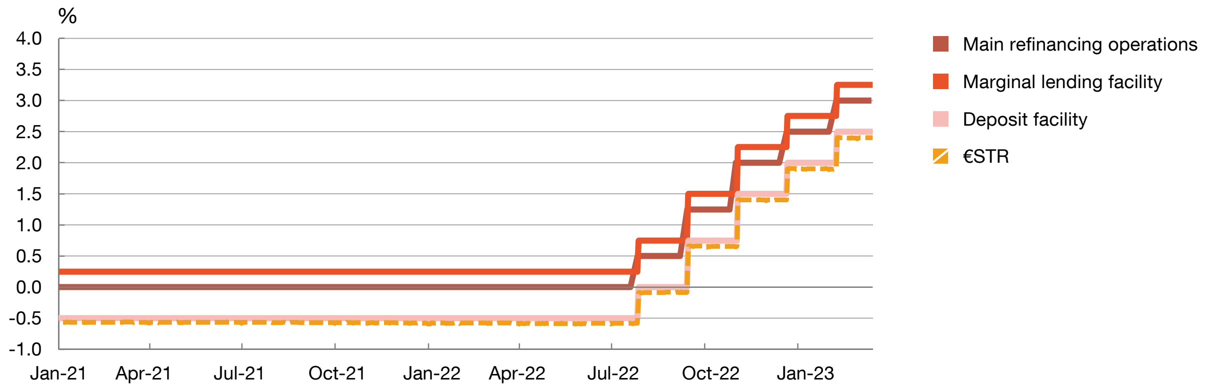
— Moreover, the Governing Council is closely monitoring the current financial market tensions and stands ready to respond as necessary to preserve price stability and financial stability in the euro area.

— It has also underlined that the euro area banking system is resilient, with strong capital and liquidity positions. In any event, the ECB's monetary policy toolkit is fully equipped to provide liquidity support to the euro area financial system, if needed, and to preserve the smooth transmission of monetary policy.

— In addition, the ECB's asset purchase programme (APP) portfolio is now declining at a measured and predictable pace of €15 billion per month on average. This rate of decline will continue up to the end of June 2023, with the subsequent pace to be determined over time.

Chart 9

9.a Key ECB interest rates and €STR



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SOURCES: Banco de España and Refinitiv Datastream. Latest data: 15/3/2023.

10 In Spain, GDP growth was higher than expected in 2022 overall, although the momentum declined as the year unfolded

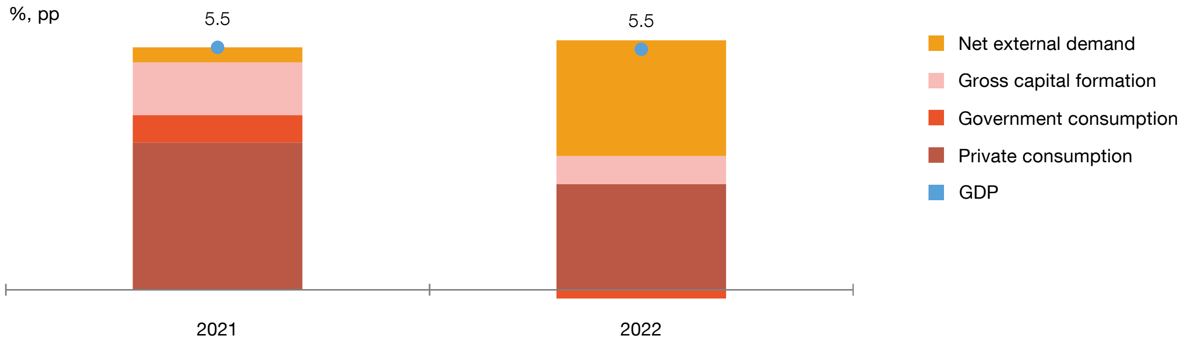
— According to the latest information published by the National Statistics Institute (INE, by its Spanish abbreviation), GDP rose by 5.5% in Spain in 2022, matching the rate of growth recorded in 2021 and above the 4.6% envisaged in the Banco de España's December macroeconomic projections.[1]

— The GDP breakdown shows that net external demand and private consumption were the main growth drivers in 2022, both linked to the end of the restrictions on mobility – once the worst phases of the pandemic were over – and the recovery in tourism and leisure activities (see Chart 10.a). Consistent with these developments, market services accounted for most of the supply-side growth in 2022.

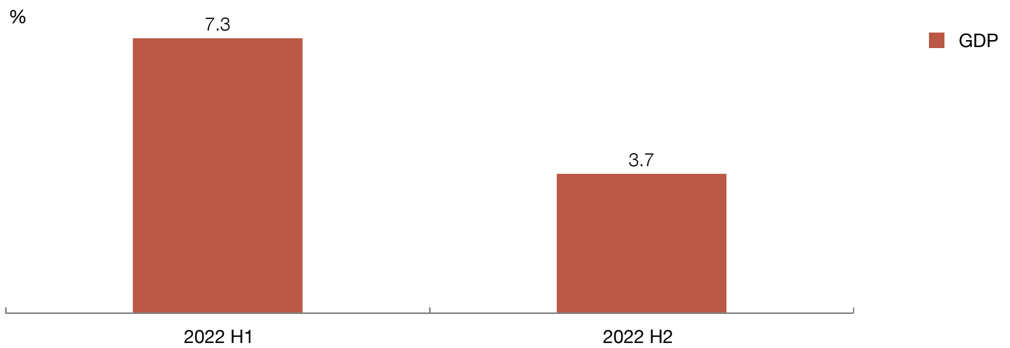
— In any event, the strong dynamism of activity in 2022 overall masked two very different half-year periods, as GDP grew by 7.3% year-on-year in the first half, but by just 3.7% in the second (see Chart 10.b).

Chart 10

10.a Spanish GDP, average growth in 2021 and 2022



10.b Spanish GDP, year-on-year growth in 2022 H1 and H2



SOURCES: Banco de España and INE.

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1 See Banco de España. (2022). "Box 1. Macroeconomic projections for the Spanish economy (2022-2025): the Banco de España's contribution to the Eurosystem's December 2022 joint forecasting exercise". In "Quarterly report on the Spanish economy". *Economic Bulletin - Banco de España,* 4/2022.

11 Output growth was relatively modest in 2022 Q4, although it surprised slightly on the upside

— Spanish GDP rose by 0.2% quarter-on-quarter in 2022 Q4, similar to the growth rate observed in Q3 and slightly above the 0.1% forecast in the Banco de España's December projection exercise (see Chart 11.a).

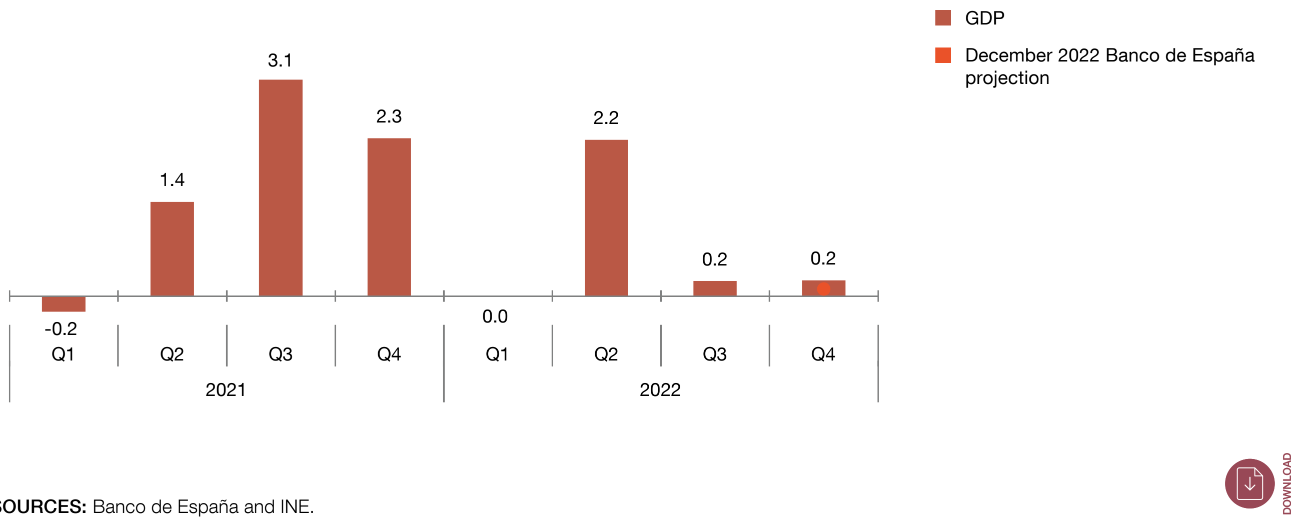
— According to the National Statistics Institute's (INE) flash estimate, economic growth in 2022 Q4 was driven mainly by net external demand, whose contribution totalled 1.1 pp, reflecting the sharper fall in imports than in exports. Meanwhile, the weakness of private consumption and investment meant that domestic demand made a negative contribution to growth (-0.9 pp).

— On the supply side, the sectors that contributed most to GDP growth in the final stretch of 2022 were the primary sector and the information and communication sector, while arts and recreation services and other service activities showed greater weakness, despite having seen very strong gains in previous quarters and having reached levels of activity in September very close to their pre-pandemic levels. Nonetheless, Spanish GDP at end-2022 was still 0.9 pp below its end-2019 level, while in the euro area as a whole GDP stood slightly more than 2 pp above that reference level.

Chart 11

11.a Spanish GDP

Quarter-on-quarter rate of change, %



SOURCES: Banco de España and INE.

12 The available indicators for 2023 Q1 suggest that GDP has grown in the quarter at a pace similar to that of the closing months of 2022

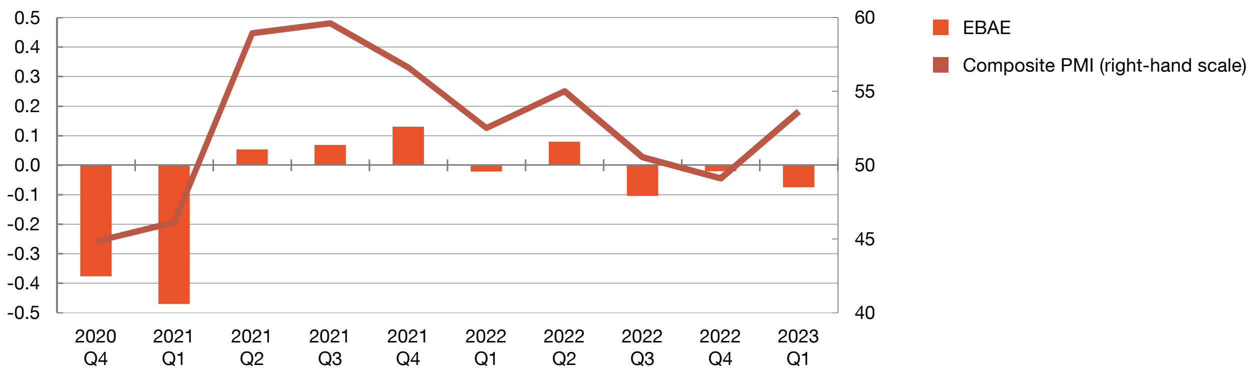
— An overall analysis of the various indicators (including employment, consumption and confidence indicators) that provide partial, and as yet incomplete, information on the performance of activity in 2023 Q1 suggests that Spanish GDP could grow in this period by 0.3% quarter-on-quarter. Nonetheless, there is considerable uncertainty surrounding this estimate.[2]

— Of note among the available indicators are the PMIs, which in January and February were higher, on average, than in the last two quarters of 2022 (see Chart 12.a).

— Meanwhile, the results of the Banco de España Business Activity Survey (EBAE) suggest that the weakness in activity seen in 2022 H2 has continued throughout 2023 Q1 (see Chart 12.a), although firms now expect a smaller decline in turnover for the current quarter than they did three months ago.[3]

Chart 12

12.a Turnover according to the EBAE and the composite PMI (a) (b)



SOURCES: Banco de España Business Activity Survey (EBAE) and S&P Global.

a The qualitative responses from the EBAE are converted into a numerical scale as follows: significant decrease = –2; slight decrease = –1; stable = 0; slight increase = 1; significant increase = 2.
b The composite PMI figure for 2023 Q1 is the average of January and February.

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2 For more details, see the Projections in this report.

3 For more details, see Alejandro Fernández and Mario Izquierdo. (2023). "Encuesta a las empresas españolas sobre la evolución de su actividad: primer trimestre de 2023". *Boletín Económico - Banco de España,* 2023/T1, 21. https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/23/T1/Fich/be2301-art21.pdf

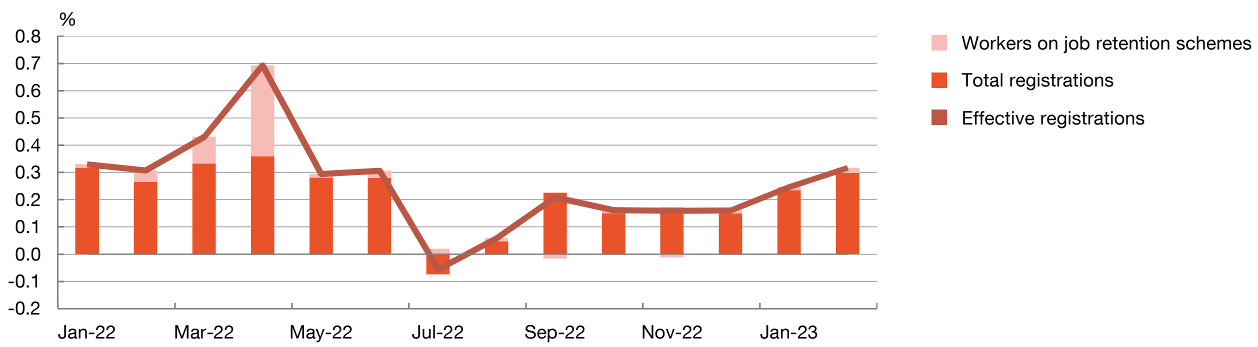
13 Job creation accelerated at the beginning of 2023 amid a decrease in the number of hours worked per worker

— Seasonally adjusted month-on-month growth in social security registrations was 0.2% in January and 0.3% in February. Both these rates were higher than those observed in the closing months of 2022 (see Chart 13.a). According to the information available for the first half of the month, employment growth appears to have intensified in March. This pick-up in employment – which was higher than expected – was observed across almost all economic sectors, with social security registrations performing particularly well in the construction sector in January and in services in February.

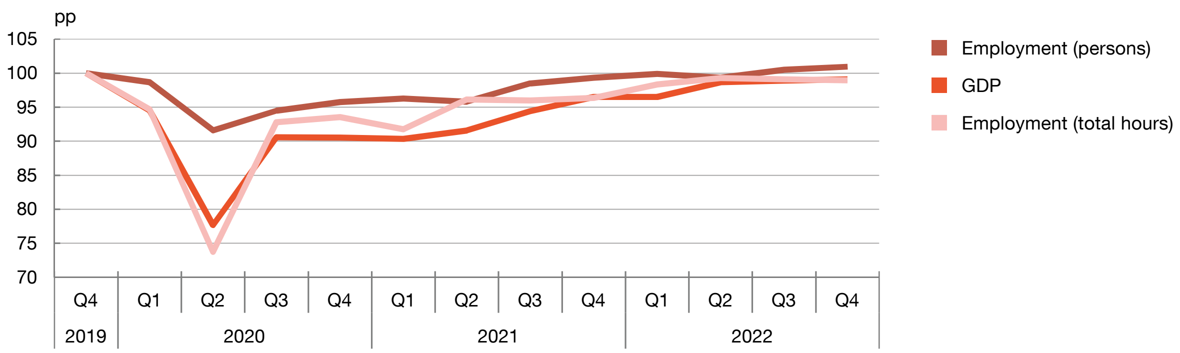
— The latest National Accounts information points to a slight decline in the number of hours worked in 2022 H2, in contrast with the relative buoyancy of employment in terms of persons employed in that same period (see Chart 13.b). Thus, the number of hours worked per worker decreased in 2022 H2, in line with the downward trend seen in Spain's average working day over the last few decades.[4]

Chart 13

13.a Total social security registrations, workers on job retention schemes and effective social security registrations (a)



13.b GDP and employment since the onset of the pandemic (2019 Q4 = 100)



SOURCES: Quarterly National Accounts (INE), Ministerio de Inclusión, Seguridad Social y Migraciones and Banco de España.

a Seasonally adjusted monthly rate.

4 For a more detailed analysis, see Pilar Cuadrado. (2023). "An analysis of hours worked per worker in Spain: trends and recent developments". *Economic Bulletin - Banco de España,* 2023/Q1, 14. https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/23/T1/Files/be2301-art14e.pdf

14 Financial conditions in Spain have continued to tighten, with a slight contraction in the volume of new lending in recent months

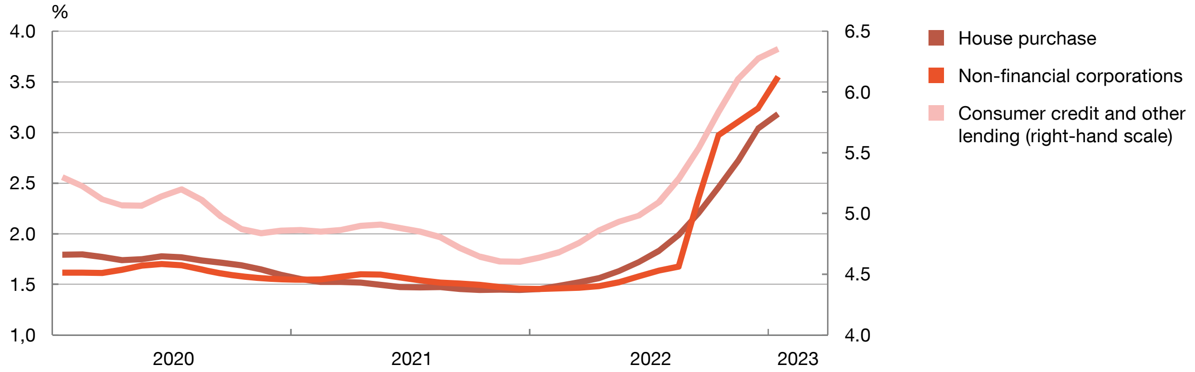
— The pass-through of higher market interest rates to the cost of new bank loans has gathered pace across all segments in recent months (see Chart 14.a). In particular, the cost of new bank loans in the corporate and house purchase segments is already similar to euro area levels, while in the consumer credit and other lending segment this cost is higher than that observed in the euro area.

— According to the Bank Lending Survey, credit standards in 2022 Q4 tightened across the board in Spain for the third quarter in a row, albeit less than anticipated by banks a quarter earlier. Meanwhile, loan demand fell in the two household segments (house purchase, and consumer credit and other lending), while demand from firms grew slightly, driven by their greater financing needs for working capital and inventories. For 2023 Q1, banks once again expect loan supply to contract and loan demand to fall across the board.

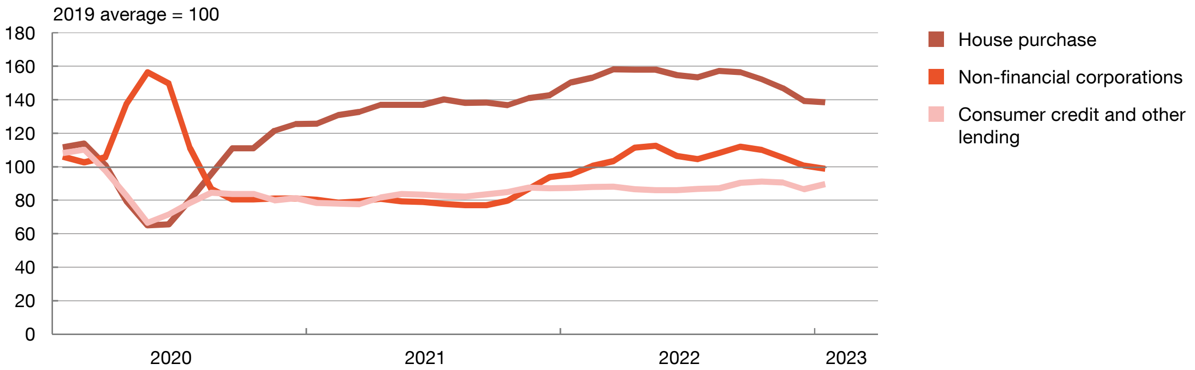
— Together, these developments have contributed to a slight contraction in the volume of new lending to households and firms in recent months (see Chart 14.b).

Chart 14

14.a Cost of new bank lending (a)



14.b New lending: 3-month cumulative seasonally adjusted flows



SOURCE: Banco de España.

a Bank interest rates are narrowly defined effective rates (NDER) and are adjusted seasonally and for the irregular component.

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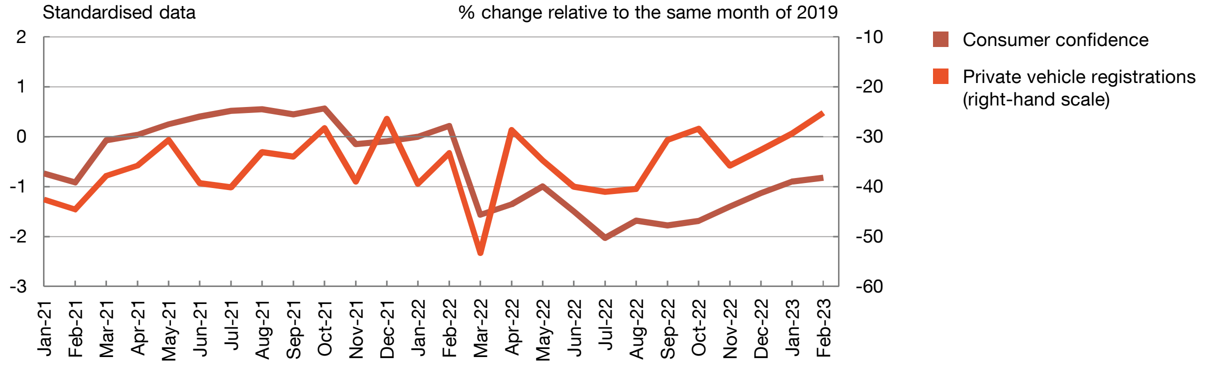
15 Household consumption appears to have remained quite weak in early 2023

— Improved confidence, the pick-up in job creation and several recent indicators (such as private vehicle registrations to February) suggest that household consumption could have been more buoyant in early 2023 than in 2022 Q4 (see Chart 15.a).

— In any event, this demand component remains rather weak, penalised by still high inflationary pressures, the continued tightening of financial conditions – whose effects on real activity have not yet fully materialised – and the lower savings buffers available.

Chart 15

15.a Household spending indicators (a)



SOURCES: European Commission, ANFAC and Banco de España.

a Standardised data 2000-2019.

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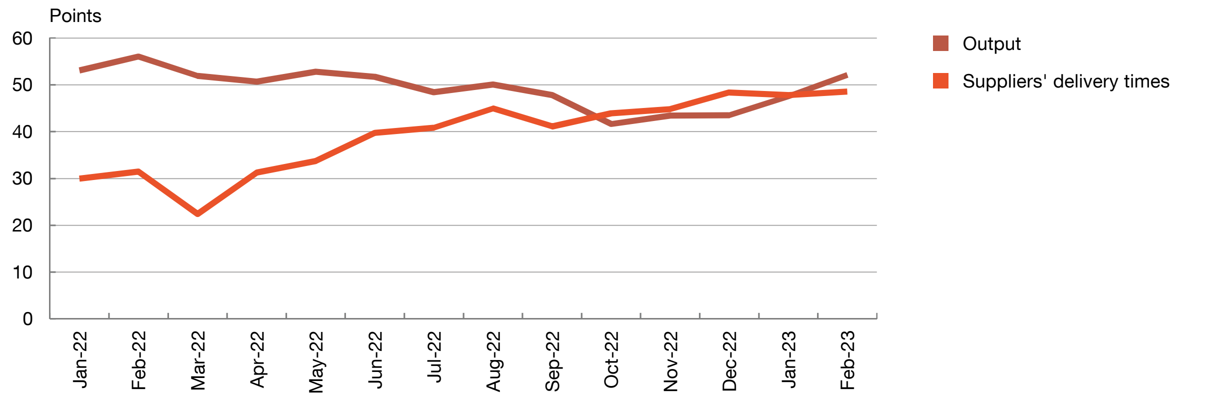
16 Business investment could rise slightly in the first few months of the year

— Although business investment displayed significant weakness throughout 2022 and some factors – such as the tightening of financial conditions and still-high levels of uncertainty – will continue to limit its future growth substantially, from a short-term perspective some recent indicators may hint at a modest upswing in business investment in the first few months of 2023.

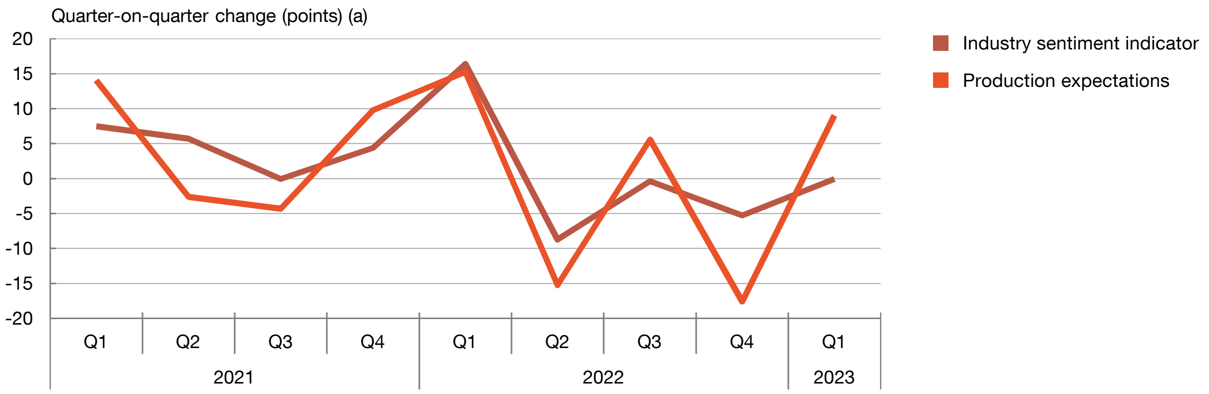
— In particular, this appears to be suggested by the fall in delivery times, the changes in the PMI indicators in January and February (see Chart 16.a), improved expectations for future activity (see Chart 16.b) and the gradual roll-out of the NGEU projects.

Chart 16

16.a Manufacturing PMIs



16.b Confidence indicators in the capital goods industry



SOURCES: IHS Markit and European Commission.

a Latest available observation: February 2023.

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17 Housing investment seems to have continued to decelerate in Q1 against a backdrop of rising costs of loans for house purchase

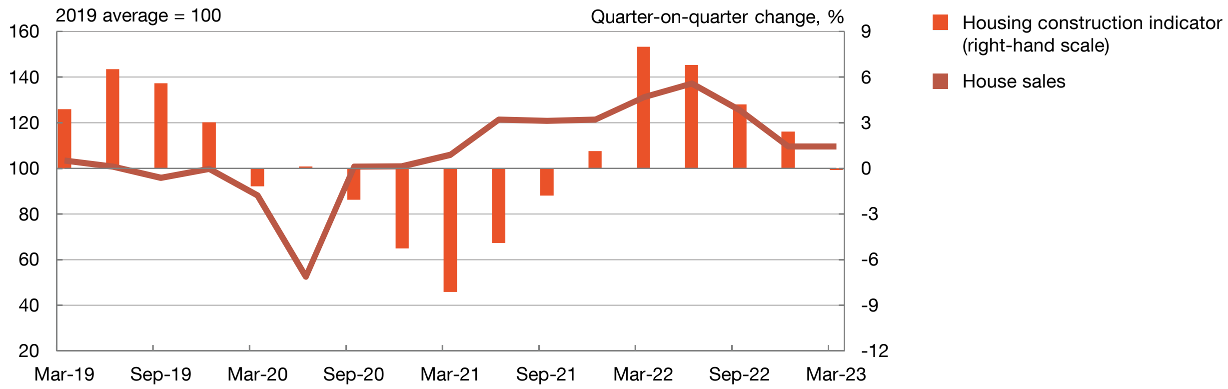
— Both the pace of housing construction and house sales continued to decline, a pattern that dates back to 2022 Q2 (see Chart 17.a).

— These developments, influenced by tightening financing conditions in recent months, which already appear to have caused a drop in new lending for house purchase, seem to point to a further slowdown in housing investment in 2023 Q1.

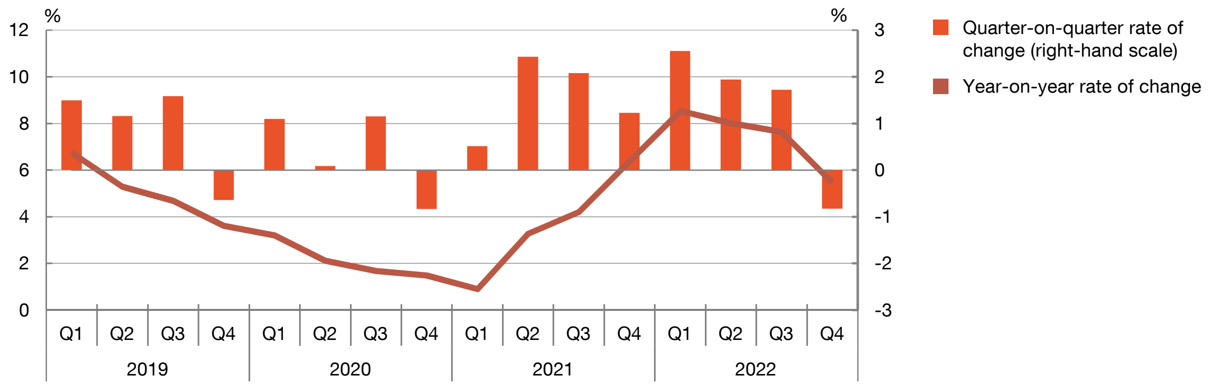
— Furthermore, although house prices have been relatively strong recently owing, in part, to supply-side constraints, the latest data suggest some slackening. In particular, house prices increased by 5.5% year-on-year in 2022 Q4, a 2.1 pp drop from 7.6% in Q3, resulting in a drop of 0.8% in house prices in quarterly terms (see Chart 17.b).

Chart 17

17.a Housing construction indicator and house sales (a)



17.b House prices



SOURCES: Banco de España, Centro de Información Estadística del Notariado, INE and Ministerio de Transportes, Movilidad y Agenda Urbana.

a Seasonally adjusted series for house sales. The latest observed data correspond to January 2023 for house sales, whose seasonally adjusted value is taken to represent 2023 Q1 as a whole. For the housing construction indicator, the time frame considered is three months from issue of the building permit to the construction start date and 18 months thereafter for the construction work; the latest data for this quarterly indicator correspond to 2023 Q1.

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18 Net exports' contribution to output growth appears to have moderated in Q1, following their significant contribution in late 2022

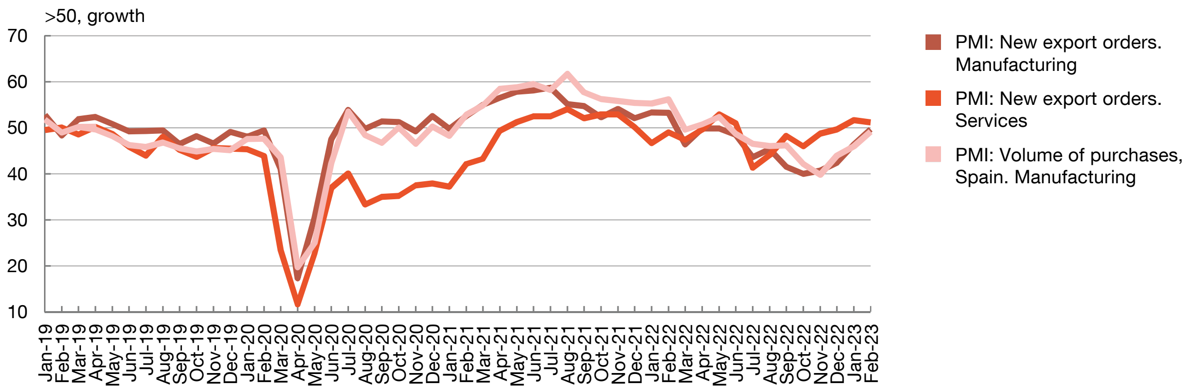
— The projected performance of external markets in 2023 Q1 and the recovery of the PMI indicators for new export orders up to February (see Chart 18.a) point to a slight uptick in goods exports in the early months of this year amid the gradual easing of bottlenecks in global supply chains.

— However, the expected rebound in business investment – with a high import content – and the emerging appreciation of the euro against the currencies of major trading partners could drive demand for imports following the weakness seen towards the end of 2022, which could reduce the contribution of net exports to GDP growth in 2023 Q1. The PMI indicators for January and February for volume of purchases in Spain, for example, point in this direction (see Chart 18.a).

— As for international tourism, the vigour shown by foreign expenditure in recent quarters (which partly reflects a larger share of higher-quality tourism)[5] appears to have led, in nominal terms, to the cumulative travel surplus in 2022 standing 6.7% above its 2019 level.

Chart 18

18.a Purchasing managers' indices



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SOURCE: Markit.

5 See Coral García Esteban, Ana Gómez-Loscos and César Martín-Machuca. (2023). "The recovery of international tourism in Spain after the pandemic". *Economic Bulletin – Banco de España*, 2023/Q1, 08. https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/23/T1/Files/be2301-art08e.pdf

19 The gradual fall in the public deficit appeared to partially reverse in the closing months of last year owing to the slowdown in government revenue

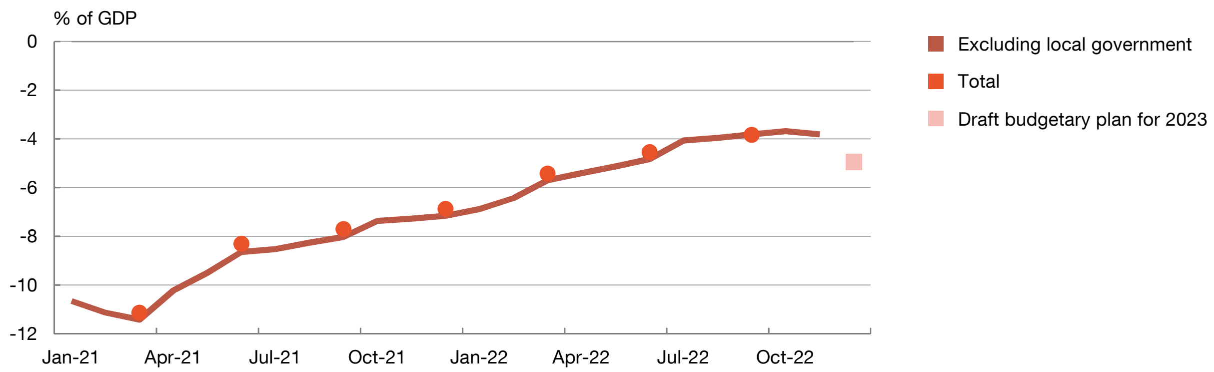
— In November, the latest month for which the IGAE has published data, the 12-month cumulative general government balance stood at -3.8% of GDP, equal to that of September and above the -5.0% forecast by the Government in its latest draft budgetary plan (see Chart 19.a).

— In the second half of 2022, up to November, the relative stability of spending growth stood in stark contrast to the marked slowdown seen in government receipts (see Chart 19.b). In particular, there was a notable slowdown in indirect taxes, which recorded negative year-on-year growth rates in October and November, with collection below what could be expected bearing in mind the tax cuts approved and the performance of their macroeconomic bases.[6]

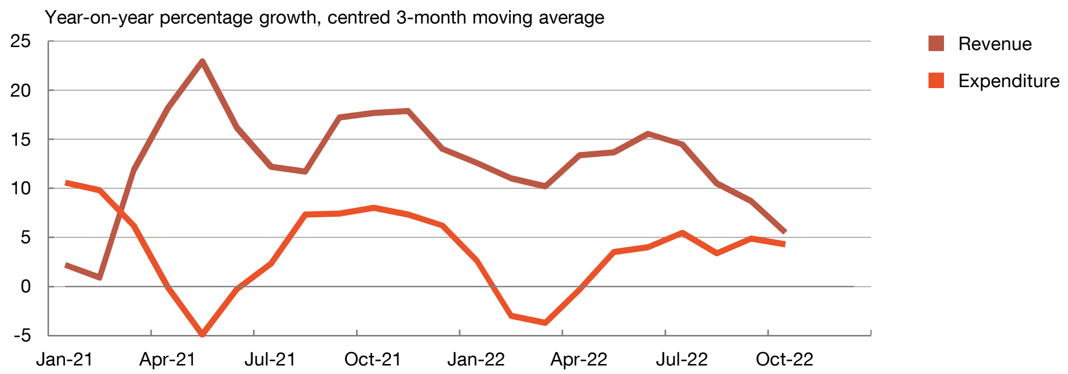
— The INE's flash estimate for 2022 Q4, while preliminary, appears to confirm the slowdown in indirect taxes, while simultaneously indicating an uptick in government consumption and subsidies in the latter part of the year.

Chart 19

19.a General government balance (a)



19.b Public revenue and expenditure (b)



SOURCES: Banco de España and IGAE.

a The National Audit Office (IGAE) only provides information on the overall general government sector on a quarterly basis.
b General government excluding both local government and transfers between different tiers of general government.

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6 This differs from the unusually positive behaviour of tax revenue in prior quarters. See Esteban García-Miralles and Jorge Martínez Pagés. (2023). "Government revenue in the wake of the pandemic. Tax residuals and inflation". *Economic Bulletin - Banco de España,* 2023/Q1, 16. https://doi.org/10.53479/29791

20 Headline inflation rose again in early 2023 as a result of some technical corrections, while the growth rate of food prices remained high ...

— The downward trend that characterised headline inflation from mid-2022 (owing fundamentally to lower energy prices) was interrupted in early 2023 by a slight upswing in inflation, from 5.5% in December 2022 to 6% in February 2023 (see Chart 20.a).

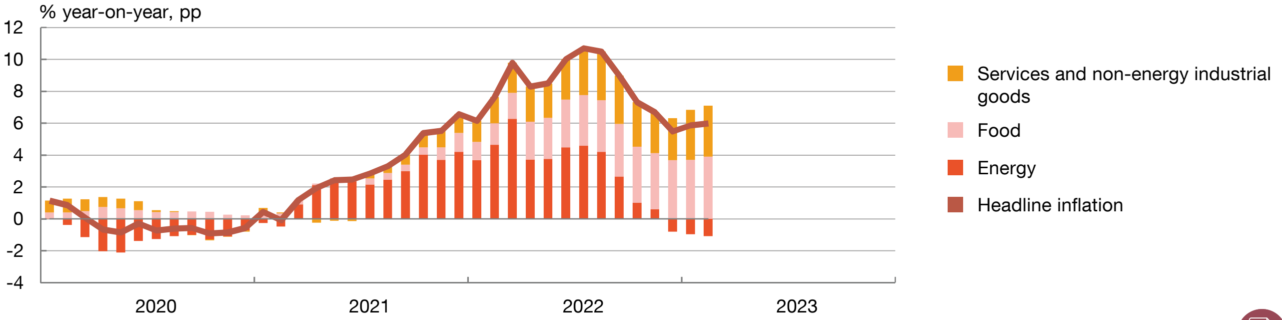
— Most of this rise is down to the impact of the general fuel discount having been limited to hauliers and other professionals in late 2022 – which appears to have lifted the year-on-year inflation rate by around 0.7 pp in January – and to several changes to the way the INE calculates the HICP as of January 2023.

— Among these changes, it is worth noting that gas and electricity prices for contracts on the free market have been incorporated into the measurement, which would have raised headline inflation in the opening months of the year by around 0.4 pp. By contrast, the annual revision of the weights, which has taken into account the reversal of changes in household consumption patterns during the pandemic, appears to have added around 0.3 pp to headline inflation in January.[7]

— Meanwhile, food price inflation accelerated slightly in early 2023 in spite of the reduction in VAT on certain basic foodstuffs introduced at the start of the year.[8] The VAT cut appears to have reduced headline inflation in January by around 0.2 pp, which would indicate that roughly 90% of the tax reduction had passed through to consumer prices.[9]

Chart 20

20.a Inflation in Spain: change and contribution of components



SOURCES: Eurostat and Banco de España.

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7 The changes entailed an increase in the weight of services in the consumption basket (from 40.2% to 45%) and decreases in the weights for energy (from 11.7% to 9.8%), food (from 25.1% to 23.4%) and non-energy industrial goods (from 22.9% to 21.3%). Also, from January 2023 the main source for the calculations of HICP weights was changed from the Spanish Household Budget Survey to the Spanish National Accounts, pursuant to the criteria laid down by European regulations.

8 Royal Decree-Law 20/2022 of 27 December 2022 reduced the rate of VAT for the following foods from 4% to 0% until 30 June: bread, baking flour, milk, cheese, eggs, fresh fruit, fresh vegetables, legumes, potatoes and cereals. VAT on oil and pasta was reduced from 10% to 5%. However, if the year on-year rate of underlying inflation is less than 5.5% in March, the VAT rates on all of these products will revert to their previous level as of 1 May 2023.

9 This impact is estimated using the difference-in-differences method. To be specific, the difference is calculated between the January 2023 month-on-month percentage change of the price of each of the subtypes of food and drink affected by the measure and the average January month-on-month percentage change from 2016 to 2022. The difference between this difference for affected items and the equivalent difference for unaffected items is then calculated. See Antonio De Amores, Salvador Barrios, Raffael Speitmann and Daniel Stoehlker. (2023). Price Effects of Temporary VAT Rate Cuts: Evidence from Spanish Supermarkets. European Commission, JRC132542 for an alternative simulation with very similar results.

21 ... and underlying inflationary pressures remain high

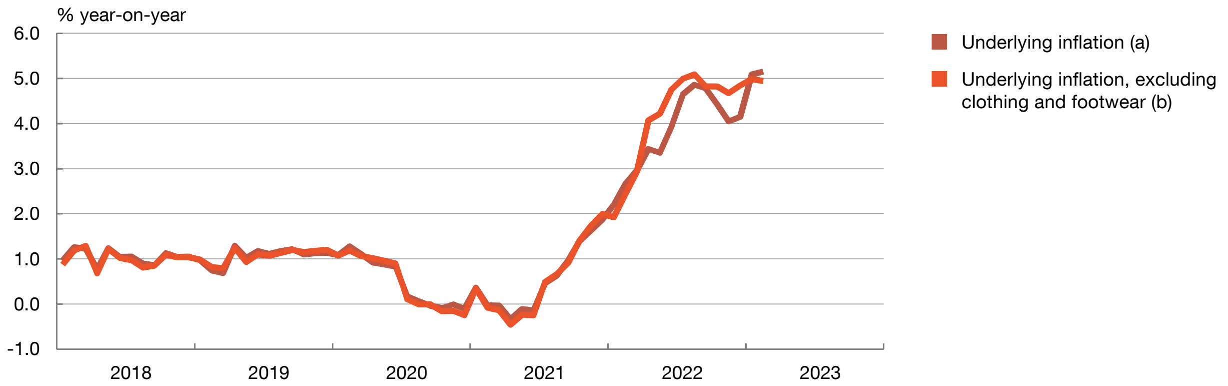
— Underlying inflation – core, excluding food and energy – reached its historical high in February, 5.2% (see Chart 21.a), despite the impact of the measures approved for transport and rentals.[10]

— In any event, the changes in underlying inflation in recent months have been highly influenced by the behaviour of clothing and footwear prices, owing to a methodological change introduced by the INE in January 2022. Excluding this component, underlying inflation has remained relatively stable since mid-2022 (see Chart 21.a).

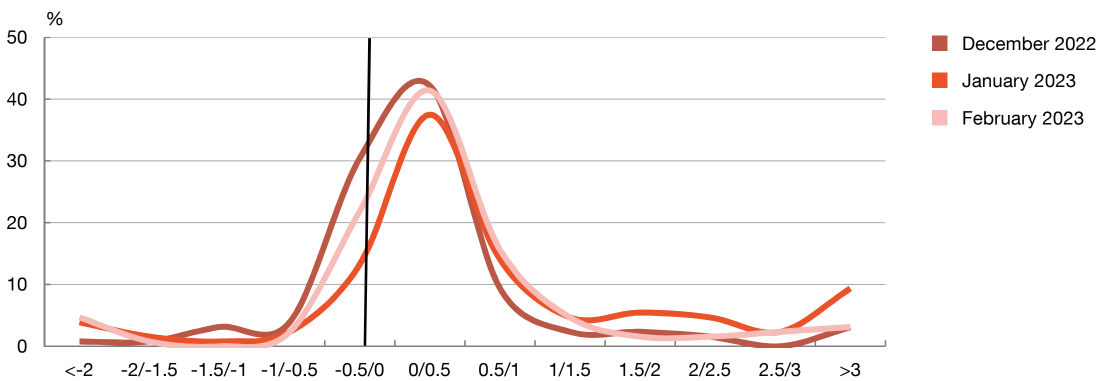
— Although the deceleration of energy costs from autumn 2022 and, more recently, of producer prices, could reduce – with some lag – underlying inflationary pressures in the coming months, in the short term, these pressures still remain very high (see Chart 21.b).

Chart 21

21.a Underlying inflation in Spain



21.b Percentage of HICP sub-classes, excluding energy and food in each range of month-on-month growth (c)



SOURCES: Eurostat and Banco de España.

a Headline inflation, excluding energy and food.
b Underlying inflation, excluding Group 03 of the ECOICOP classification (Clothing and footwear).
c Month-on-month rates corrected for average rates in the period 2016-2019, for each month.

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10 In particular, Royal Decree-Law 20/2022 of 27 December 2022, approved measures relating to discounts on certain passenger land transport tickets and extended the 2% cap on housing rent increases. Overall, these measures detracted between 0.5 pp and 0.6 pp from underlying inflation in January 2023.

22 Wages continue to increase moderately in the early months of 2023…

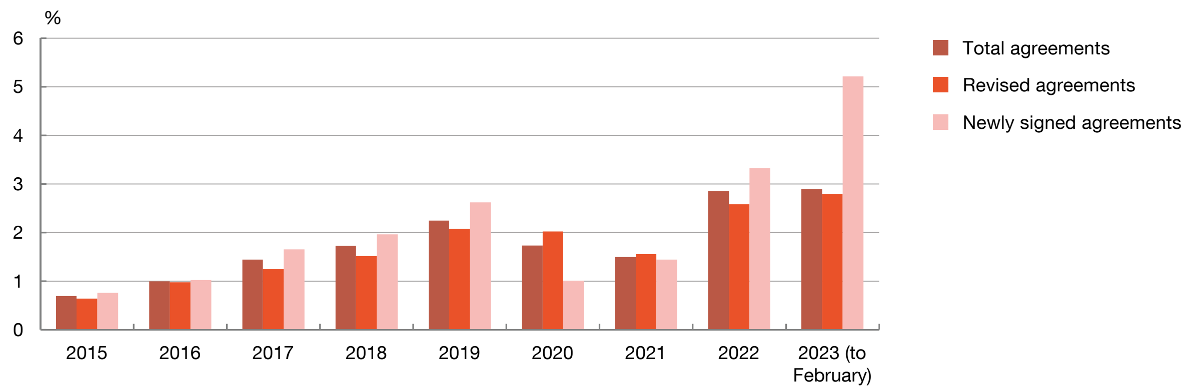
— According to the information available to February, the average negotiated wage increase under collective agreements in force in 2023 was 2.9%, in line with the increases agreed for 2022 (see Chart 22.a). However, this figure mostly reflects the increase negotiated in agreements signed in previous years, while new collective agreements signed over the course of 2022 H2 point to an average wage increase of 3.3%. For their part, collective agreements signed in the first two months of 2023 envisage an increase of 5.2%, but only affect 245,000 workers; therefore, they are not very representative.

— The prevalence of indexation clauses in the collective agreements signed for 2023 stood at 27.4%, slightly above that observed in 2022 (see Chart 22.b).

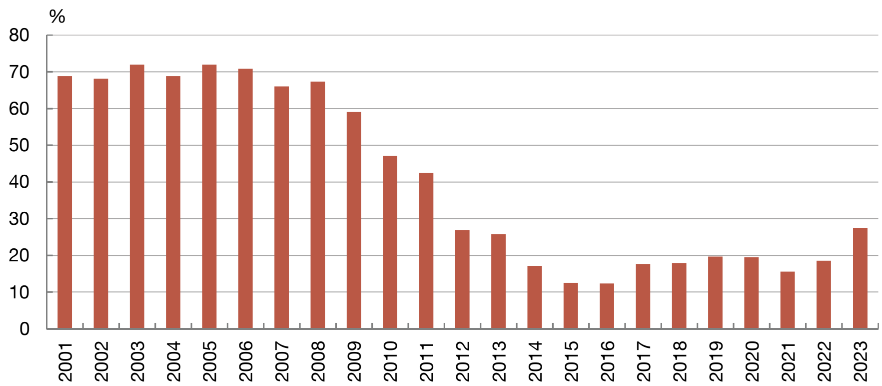
— The indexation clauses signed for 2022 seem to have led to an upward revision of the wage increases agreed that year of around 0.2 pp,[11] similar to that estimated for 2021.[12]

Chart 22

22.a Wage settlement



22.b Prevalence of indexation clauses



SOURCE: Ministerio de Trabajo y Economía Social.

11 According to the first figures published by the Ministry of Labour and Social Economy on the revised wage increase for 2022.

12 The coverage provided by indexation clauses against inflation surprises was around 40%, in line with that observed in recent years. See Mario Izquierdo and José Luis Herrera. (2022). "Box 6. Recent indexation clauses: an analysis". In "Quarterly report on the Spanish economy". *Economic Bulletin - Banco de España,* 3/2022, pp. 59-61. https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/22/T3/Files/be2203-it-Box6.pdf

23 … while there seems to have been a certain rebound in profit margins throughout 2022, albeit with high heterogeneity across sectors and firms

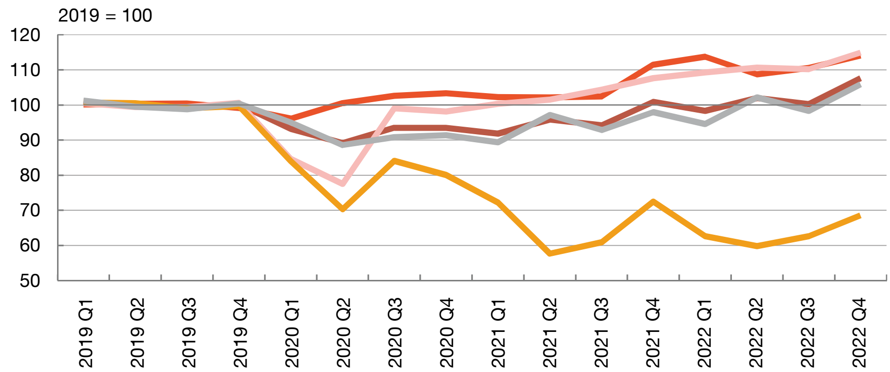
— According to the provisional National Accounts data for 2022 Q4, the ratio of gross operating surplus (GOS) to gross value added (GVA) in the market economy increased in the final stretch of 2022 to levels slightly above those recorded pre-pandemic (see Chart 23.a).

— This is consistent with the behaviour of the ratio of gross operating profit (GOP) to GVA observed, until end-2022, in the sample of firms in the Banco de España's Central Balance Sheet Data Office Quarterly Survey (CBQ). However, it should be noted that in the CBQ profit margins approximated as the ratio of GOP to turnover remained practically stable in 2022 and are still below the level recorded in 2019 (see Chart 23.b).

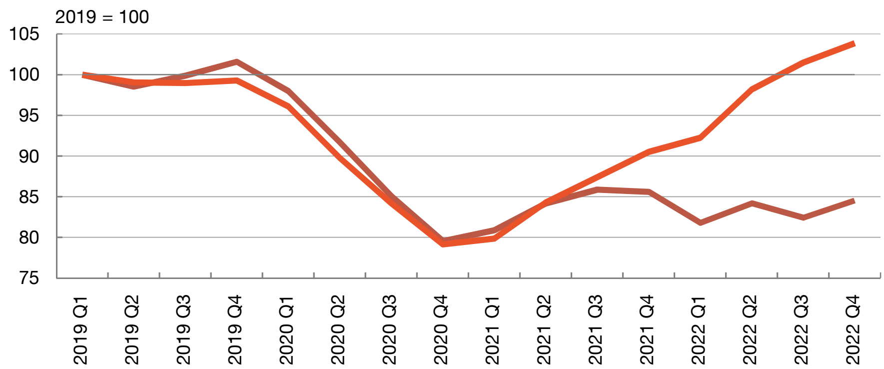
— In any event, as in previous quarters, these aggregate developments mask substantial heterogeneity across sectors and firms.[13]

Chart 23

23.a Changes in profit margins (GOS/GVA) according to National Accounts data. Breakdown by sector



23.b Changes in profit margins according to CBQ data (a)



SOURCES: Banco de España and INE.

a Margin on sales is defined as the ratio of GOP to net turnover. Margin on GVA is defined as the ratio of GOP to GVA. Four-quarter cumulative data.

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13 See, for instance, "Quarterly report on the Spanish economy", *Economic Bulletin - Banco de España,* 4/2022, and "Box 1. Recent developments in firms' profit margins drawing on Central Balance Sheet Data Office data". In "Economic and financial performance of Spanish firms in 2021 and in the first three quarters of 2022 according to the Central Balance Sheet Data Office", *Economic Bulletin - Banco de España,* 4/2022.

24 The Banco de España's latest macroeconomic projections revise GDP growth slightly upwards for 2023

— The last section of this report describes the key features of the Banco de España's latest macroeconomic projections over the horizon 2023-2025. These projections were completed in early March, prior to the emergence of the recent tensions in the international financial markets.

— Under the assumptions of the exercise, Spanish GDP is projected to grow by 1.6%, 2.3%, and 2.1% in 2023, 2024 and 2025, respectively.

— Compared with the projections published in December, the current projections revise GDP growth for 2023 up by 0.3 pp, essentially as a result of greater growth than expected in 2022, which entails a positive carry-over effect on the annual average growth rate in 2023. In addition, the assumptions relating to external markets and fiscal variables are now somewhat more favourable for growth in 2023, offsetting the negative impact associated with the upward revision to the future path of interest rates over the projection horizon. Conversely, the growth projected for 2024 has been revised downwards by 0.4 pp to 2.3%, while that for 2025 remains unchanged.

— Compared with the previous projections, the average inflation rate for 2023 is revised downwards by 1.2 pp to 3.7%. This revision is mainly explained by the energy component, while food prices and the underlying component are revised up. As regards the rest of the projection horizon, headline inflation rates are expected to decline to 3.6% in 2024 and to 1.8% in 2025.

— Against a backdrop of high uncertainty, the risks to the projections are trending downwards in terms of economic activity and are balanced for inflation.

Figure 1

	2023	2024	2025
GDP	1.6% ↑ 0.3 pp	2.3% ↓ 0.4 pp	2.1% 0.0 pp
Inflation	3.7% ↓ 1.2 pp	3.6% 0.0 pp	1.8% 0.0 pp

SOURCE: Banco de España.

MACROECONOMIC PROJECTIONS FOR THE SPANISH ECONOMY (2023-2025)

Macroeconomic projections for the Spanish economy (2023-2025)

This section describes the key features of the most recent update to the Banco de España's macroeconomic projections for the Spanish economy, the final version of which was completed in early March, before the appearance of tensions on the international financial markets. Under the assumptions of the exercise, Spanish GDP – which grew by 5.5% in real terms in 2022 – is projected to rise by 1.6%, 2.3% and 2.1% in 2023, 2024 and 2025, respectively (see Table 1).[1] On the price side, headline inflation – which stood at 8.3% on average in 2022 – will fall to 3.7% in 2023, before remaining virtually unchanged in 2024 (at 3.6%) and declining to 1.8% in 2025. Meanwhile, underlying inflation will stand at 3.9% this year (0.1 percentage points (pp) higher than in 2022) before slowing to 2.2% and 1.8% over the next two years.

Activity

Economic activity in Spain was lacklustre in the last quarter of 2022. Specifically, as per the flash estimates published by the National Statistics Institute (INE), GDP grew by 0.2% (unchanged on Q3), 0.1 pp more than predicted by the Banco de España in its December projections.[2] In the last three months of 2022, high inflation and increasingly tight financial conditions made for a complex setting for private agents' spending decisions. Against this backdrop, falling domestic demand deducted 0.9 pp from output growth in Q4, with significant declines in private consumption and gross capital formation. Imports also fell, in line with this weaker domestic demand, and did so considerably faster than exports. Thus, in net terms, external demand made a positive contribution (of 1.1 pp) to GDP growth over this period. Moreover, at the same time as publishing the 2022 Q4 data, the INE also revised the figures for the rest of the year, indicating more robust activity than had previously been estimated in the first and, above all, second quarters.

A combination of various adverse factors has continued to weigh down on business and household spending in early 2023. Such factors notably include the overall loss of household purchasing power since the start of the current inflationary episode. Although this decline has slowed, its persistence over recent months has gradually eroded the ability to counter its effects

1 The projections incorporate the new information that became available between the cut-off date of the previous projections and 2 March, the cut-off date of the current projections (save with respect to the assumptions regarding developments in export markets, which come from the European Central Bank (ECB)'s March macroeconomic projections for the euro area). Consequently, they do not include any information regarding the episode of significant financial market strain that began on 8 March. Conversely, the new information considered includes the flash Quarterly National Accounts (QNA) estimate for 2022 Q4 – which also entailed significant revisions to the data for the three preceding quarters – and the Quarterly Non-Financial Accounts for the Institutional Sectors (QNFAIS) for 2022 Q3, together with the higher-frequency information that has come to light since the previous projections were prepared. The projections also factor in the changes observed in the technical assumptions used as a starting point for projecting the different macroeconomic aggregates (see Table 2).

2 "Box 1. Macroeconomic projections for the Spanish economy (2022-2025): the Banco de España's contribution to the Eurosystem's December 2022 joint forecasting exercise". *Economic Bulletin - Banco de España,* 4/2022.

Table 1
Macroeconomic projections for the Spanish economy (2023-2025) (a)

Annual rate of change (%)

	GDP				HICP				HICP excluding energy and food				Unemployment rate (% of labour force) (b)			
	2022	2023	2024	2025	2022	2023	2024	2025	2022	2023	2024	2025	2022	2023	2024	2025
March 2023	5.5	1.6	2.3	2.1	8.3	3.7	3.6	1.8	3.8	3.9	2.2	1.8	12.9	12.7	12.3	12.0
December 2022	4.6	1.3	2.7	2.1	8.4	4.9	3.6	1.8	3.8	3.4	2.2	1.8	12.8	12.9	12.2	12.0

SOURCES: Banco de España and INE.
NOTE: Latest QNA figure published: 2022 Q4.

a Projections cut-off date: 2 March 2023..
b Annual average.

Table 2
International environment and monetary and financial conditions (a)

Annual rate of change (%), unless otherwise indicated

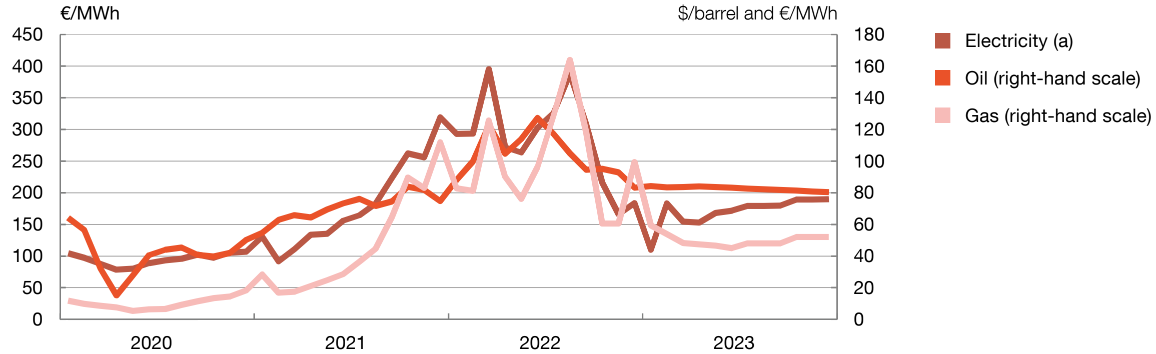
		March 2023 projections			Difference between the current projections and the December 2022 projections (b)		
	2022	2023	2024	2025	2023	2024	2025
Spain's export markets (c)	8.0	2.6	3.0	3.1	0.5	-0.1	0.0
Oil price in dollars/barrel (level)	103.7	81.9	77.2	73.6	-4.5	-2.5	-2.4
Monetary and financial conditions							
Dollar/euro exchange rate (level)	1.05	1.06	1.06	1.06	0.04	0.03	0.03
Nominal effective exchange rate against non-euro area countries (d) (2000 = 100)	112.1	114.0	113.9	113.9	2.8	2.6	2.6
Short-term interest rates (3-month EURIBOR. Level) (e)	0.3	3.5	3.7	3.2	0.6	1.0	0.7
Long-term interest rates (10-year Spanish government bond yield. Level) (e)	2.2	3.7	3.9	4.0	0.8	0.8	0.8

SOURCES: ECB and Banco de España.
NOTE: Latest QNA figure published: 2022 Q4.

a Cut-off date for assumptions: 15 February 2023 for Spain's export markets and 2 March 2023 for all other variables. Figures expressed as levels are annual averages; the figures expressed as rates are calculated on the basis of the related annual averages.
b The differences are in rates for export markets, in levels for oil prices, the dollar/euro exchange rate and the nominal effective exchange rate, and in percentage points for interest rates.
c The assumptions regarding the behaviour of Spain's export markets presented in the table are obtained from the March 2023 Eurosystem staff macroeconomic projections for the euro area.
d A positive percentage change in the nominal effective exchange rate denotes an appreciation of the euro.
e For the projection period, the figures in the table are technical assumptions, prepared following the Eurosystem's methodology. These assumptions are based on futures market prices or on proxies thereof and should not be interpreted as a Eurosystem prediction as to the course of these variables.

Chart 1

1.a Energy prices



SOURCES: Mercado Ibérico del Gas, Operador del Mercado Ibérico-Polo Portugués and Reuters.

a Regulated rate for small consumers of electricity.

on spending by further reducing the saving rate.[3] Second, household and business spending has been affected (to an increasingly significant degree) by the progressive tightening of financial conditions since early 2022, due to a change in the monetary policy stance in the euro area in a context of high inflationary pressures. Specifically, since July last year the ECB has hiked its policy interest rates by 3.5 pp overall, 1.5 pp of which are the result of decisions adopted at its last three monetary policy meetings (in December 2022 and February and March this year). In step with this tightening of the monetary policy stance, the cost of borrowing by public and private agents has continued to rise in recent months. Indeed, in the specific case of bank lending, the rise in market interest rates has increasingly been passed through to the cost of new loans across all segments, as appears to be borne out by the slowdown in financing raised by firms and households, which is now showing a slight decline.

Cheaper energy prices have helped to counter these less favourable developments and have recently gone some way to boosting aggregate activity. In 2022 H2, the price of natural gas on the European and Spanish markets started to fall, a trend that has held in the opening months of 2023, thereby reversing – to a greater extent than initially envisaged – the negative supply-side shock that hit European economies particularly hard in the final stretch of 2021 and the first half of 2022 (see Chart 1). Indeed, this commodity is currently trading at levels similar to, or even lower than, the pre-Ukraine war price, thanks to the fall in demand – owing to the mild temperatures in the first half of winter and the measures rolled out to discourage consumption – and the diversification of supply sources. All of which means that Europe’s gas reserves are more

3 In any event, the measures rolled out by the authorities to address the consequences of the energy crisis, which have been renewed on several occasions, have continued providing a degree of support to households' and firms' purchasing power. For an assessment of the impact of these measures on households by income level, see García-Miralles, Esteban (2023). “Support measures in the face of the energy crisis and the upswing in inflation: an analysis of the cost and distributional effects of some of the measures rolled out based on their degree of targeting”, *Economic Bulletin - Banco de España,* 2023/1, 15. https://doi.org/10.53479/29769

plentiful than tends to be the case at this time of year, thus lessening the risk of supply cut-offs and helping to restore the confidence of economic agents and boost activity.

Moreover, the reopening of the Chinese economy after the country abandoned its zero-COVID policy has helped improve the global outlook for activity. In any event, the scale (and even the direction) of the effects of this reopening on global inflation dynamics are uncertain. On the one hand, in a context of fewer health restrictions in China, more robust activity in the Asian economy is likely to entail greater demand for goods produced elsewhere and for commodities, thereby exerting a degree of upward pressure on prices at a global level. This could, in turn, trigger a more contractionary monetary policy stance from some of the world's main central banks, such as the ECB. Conversely, the reopening of the Chinese economy could help to clear some of the bottlenecks that still remain in global production and logistics chains more quickly. This might help to mitigate the inflationary pressures that, although less acute than in previous quarters, still exist as a result of these mismatches between the global supply and demand for certain goods.

Overall, as a result of these developments and based on the as yet incomplete information offered by the most recent activity indicators, the Spanish economy appears to be performing somewhat better in the opening months of 2023 than had been anticipated in December. This is suggested, for instance, by the gradual improvement in confidence indicators seen in recent months. In terms of quantitative indicators, the pace of growth in social security registrations quickened in January and, above all, February, when compared with the final months of 2022. Moreover, tourism has continued to recover, as indicated by the statistics on overnight stays by foreign tourists, which in January reached the pre-COVID figures for the first time since the start of the pandemic. Meanwhile, according to the Banco de España Business Activity Survey (EBAE),[4] firms' perception of their turnover in 2023 Q1 was somewhat more encouraging than their expectations for this period in the previous round of the survey. With all of this in mind, subject to the caveats stemming from the partial nature of such information, quarter-on-quarter GDP growth is projected to stand at 0.3% in the first quarter of the year.

From spring onwards, economic activity is expected to gather momentum, albeit in a still highly uncertain setting in which various factors will continue to somewhat weaken the macro-financial dynamics of the Spanish economy. The faster pace of output growth will be helped, among other factors, by the expected easing of inflationary pressures – resulting in the recovery of agents' confidence and real income –, an end to the disruptions that still trouble global supply chains and the greater deployment of the Next Generation EU (NGEU) funds. However, economic growth will be constrained by a potential further tightening of financial conditions – in line with the current expectations on the financial markets –, as well as by the culmination of the pass-through of past market interest rate hikes to new lending rates and to the financial burden of borrowers – in other words, due to the delayed impact on activity likely to stem from the cumulative tightening of monetary policy that has already taken place.

4 Mario Izquierdo (2023). "Encuesta a las empresas españolas sobre la evolución de su actividad: primer trimestre de 2023", *Economic Bulletin - Banco de España*, 1/2023, Analytical Articles.

Table 3
Projections for the main macroeconomic aggregates of the Spanish economy (a)

Annual rate of change in volume terms (%) and % of GDP

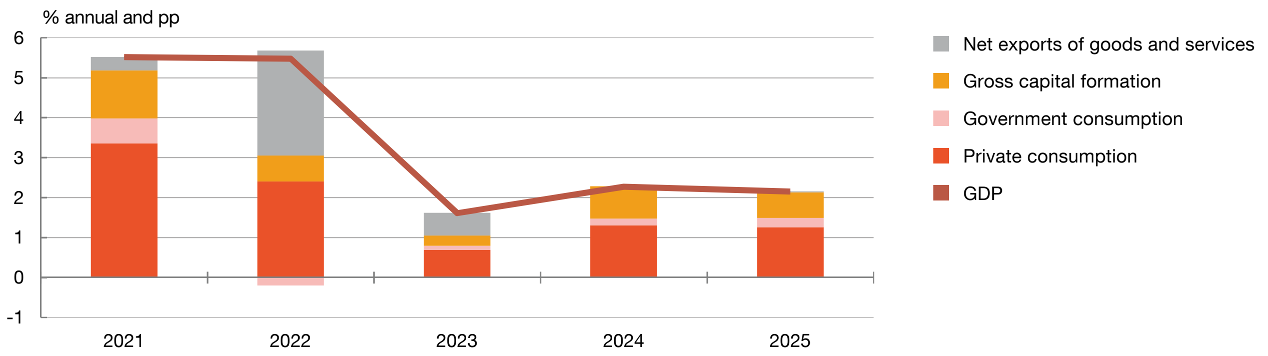
		March 2023 projections			December 2022 projections		
	2022	2023	2024	2025	2023	2024	2025
GDP	5.5	1.6	2.3	2.1	1.3	2.7	2.1
Private consumption	4.3	1.2	2.3	2.2	1.9	2.8	2.1
Government consumption	-0.9	0.5	0.8	1.2	0.3	0.9	1.2
Gross fixed capital formation	4.3	0.3	3.9	3.0	1.6	3.0	2.3
Exports of goods and services	14.9	3.1	2.9	3.0	3.8	3.0	3.1
Imports of goods and services	7.7	1.8	3.1	3.1	4.3	2.5	2.9
Domestic demand (contribution to growth)	2.9	1.0	2.3	2.1	1.4	2.4	1.9
Net external demand (contribution to growth)	2.6	0.6	0.0	0.0	-0.1	0.3	0.2
Nominal GDP	10.1	5.3	5.4	4.1	5.8	5.9	4.4
GDP deflator	4.4	3.6	3.0	1.9	4.5	3.2	2.2
HICP	8.3	3.7	3.6	1.8	4.9	3.6	1.8
HICP excluding energy and food	3.8	3.9	2.2	1.8	3.4	2.2	1.8
Employment (hours)	4.1	0.9	1.3	1.0	0.5	1.6	1.1
Unemployment rate (% of labour force). Annual average	12.9	12.7	12.3	12.0	12.9	12.2	12.0
Net lending (+)/net borrowing (-) of the nation (% of GDP)	2.1	2.3	2.1	1.5	2.1	2.4	2.3
General government net lending (+)/net borrowing (-) (% of GDP)	-4.6	-4.1	-3.5	-4.4	-4.1	-3.7	-4.5
General government debt (% of GDP)	113.1	111.1	108.8	109.9	110.6	108.8	109.8

SOURCES: Banco de España and INE.
NOTE: Latest QNA figure published: 2022 Q4.

a Projections cut-off date: 2 March 2023.

Chart 2

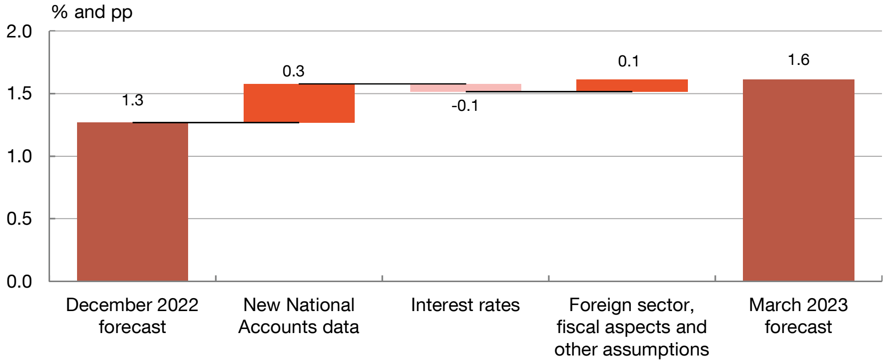
2.a GDP growth and contributions of main components



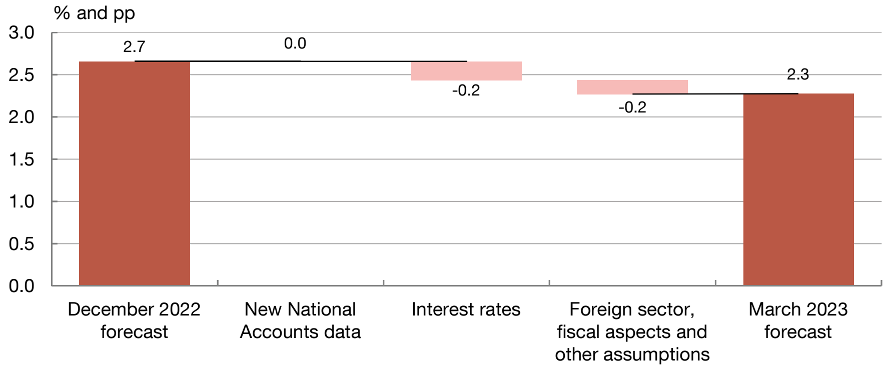
SOURCES: INE and Banco de España.

Chart 3

3.a Changes in the GDP growth forecast for 2023



3.b Changes in the GDP growth forecast for 2024



SOURCES: INE and Banco de España.

In average annual terms, GDP growth is set to slow substantially in 2023, to 1.6% (see Table 3 and Chart 2). The slowdown with respect to 2023 (of 3.9 pp) can be explained by weak activity in 2022 H2 – which exerts a negative carry-over effect[5] on the average GDP growth rate in 2023 – and the first quarter of this year, without this weakness ultimately being offset by the progressively higher growth expected in the rest of the year. Nonetheless, the increasing pace of output growth over the course of 2023 – based essentially on the recovery of private consumption and of gross capital formation – will yield an average annual growth rate of 2.3% in 2024, before slowing to 2.1% in 2025, a figure that would still exceed the Spanish economy's potential growth rate. Under the projected trajectory, Spanish GDP will return to its pre-pandemic level in the second half of this year.

Job creation will continue over the projection horizon, in line with the growth in activity. Despite the increase in the labour force, the unemployment rate will continue to fall thanks to rising employment.

5 José González Mínguez and Carmen Martínez Carrascal (2019), "The relationship between average annual and quarter-on-quarter GDP growth rates: implications for projections and macroeconomic analysis", *Economic Bulletin - Banco de España*, 3/2019, Analytical Articles.

As compared with those published three months ago, the current projections revise up GDP growth for 2023 by 0.3 pp (see Chart 3.a). This mainly owes to the flash QNA data for 2022 Q4, published by the INE in late January, and their carry-over effect on the annual average rate for 2023. As mentioned above, these provisional figures entail a substantial upward revision to the GDP growth rate for 2022 H1 and a slight positive surprise in output growth for 2022 Q4 compared with that envisaged in the Banco de España's December projections. The new assumptions underlying the projection exercise also have a slight net positive impact on GDP growth in 2023. In particular, the assumptions relating to overseas markets and fiscal variables are now somewhat more conducive to growth this year, offsetting the negative impact associated with the upward revision to the future path of interest rates. Conversely, the changes to the assumptions translate into a downward revision of 0.4 pp to GDP growth for 2024 (see Chart 3.b).

Prices and costs

Prices of energy consumer goods have declined significantly in recent months, causing annual energy inflation rates to turn negative since the beginning of the year. As noted above, gas prices in particular have fallen very sharply. Two further factors have also influenced energy price dynamics: (i) the discontinuance, at the end of last year, of the general subsidy of €0.20 per litre of fuel purchased (already factored into the baseline scenario of the Banco de España's December projection exercise), and (ii) the methodological change, introduced at the start of 2023, to the INE's measurement of electricity and gas price developments.[6]

Despite the sharp energy price correction, headline inflation climbed to 6% in February, ending the downward trend followed by this variable between July and December 2022 (see Chart 4.a). This reflected the broad-based pick-up in inflation across all non-energy aggregates: food (whose inflation rate has only partially been eased by the introduction of reduced VAT rates on some items since the start of the year),[7] non-energy industrial goods and services. In particular, underlying inflation rose from 4.1% in December to 5.2% in February, the highest level since the series began 1997. These underlying inflation developments probably owe to the fact that past increases in energy costs (which pass through with something of a lag) did not fully feed through to the final prices of consumer goods and services during 2022. Further, the downward stickiness of underlying inflation may also owe to potential pass-through asymmetries, whereby declining energy prices (such as those observed recently) may pass through less robustly or with a longer lag than rising energy prices (such as those seen during much of 2021 and in 2022 H1).

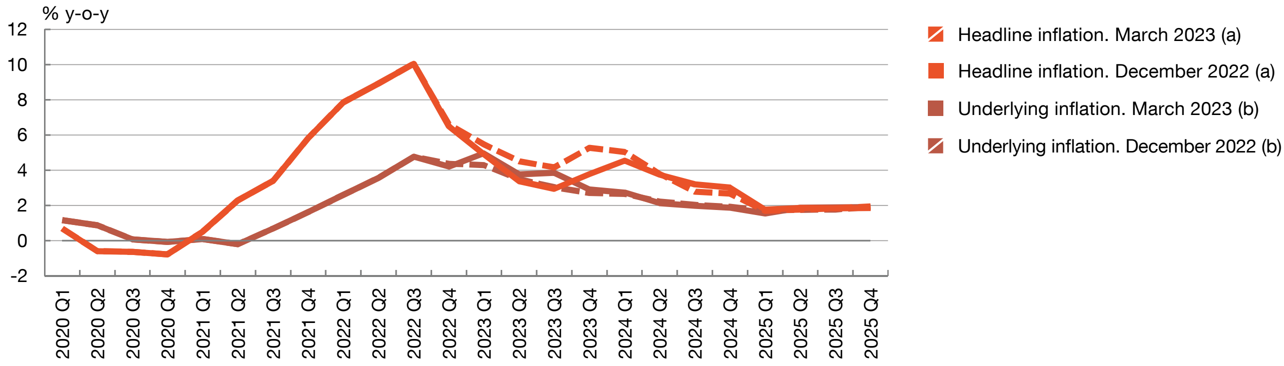
Headline HICP is expected to gradually ease from its current levels over the projection horizon. In 2023, this will largely be due to the expected decline in the energy component's

6 Since January, the INE has included free market contracts in its gas and electricity price calculations. Taken in isolation, it is estimated that this change increased headline inflation in January by 0.4 pp.

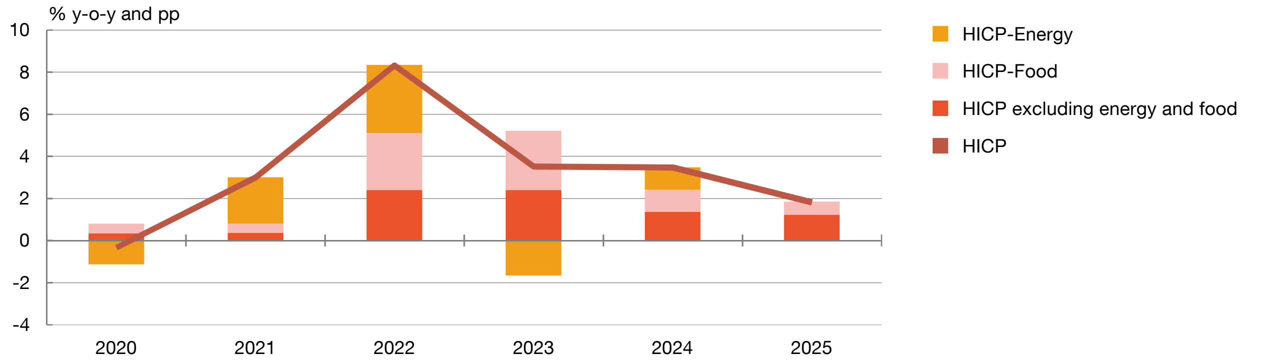
7 Royal Decree-Law 20/2022, of 27 December 2022, reduced the rate of VAT for the following foods from 4% to 0% until 30 June 2023: bread, baking flour, milk, cheese, eggs, fresh fruit, fresh vegetables, legumes, potatoes and cereals. The VAT rate on oil and pasta was reduced from 10% to 5%. However, if the year on-year rate of underlying inflation for the month of March is less than 5.5%, the VAT rates on all of these products will return to their previous level as of 1 May 2023.

Chart 4

4.a Headline and underlying inflation



4.b HICP: growth and contribution of components



SOURCES: INE and Banco de España.

a Measured by the HICP.
b Measured by the HICP excluding energy and food.

contribution to price growth (see Chart 4.b), which is driven by two main factors. First, negative base effects, since the year-on-year price growth for the coming months will be measured against price levels in the equivalent months in 2022, when the escalating energy crisis caused prices to soar. Second, based on futures markets, energy commodity prices are expected to decline over the coming months, leading to further reductions in fuel and gas prices. All of which will cause annual average inflation to ease from 8.3% in 2022 to 3.7% in 2023. The projections assume that the main measures deployed by authorities to mitigate the effects of the energy crisis will expire at end-2023, which would prevent any further significant reduction in the average headline inflation rate in 2024. In fact, in that year rising energy prices will virtually offset the anticipated easing of both underlying and food inflation. As a result, headline inflation will hold at 3.6% in 2024, before declining again in the final year of the projection horizon to 1.8%.

Underlying inflation is expected to ease more slowly than headline inflation over the projection horizon (see Chart 4.a). Indeed, recent developments indicate that underlying inflation, despite beginning to ease around spring, will rise by 0.1 pp in 2023 (to 3.9% on average) as compared with the figure for 2022. The gradual deceleration in underlying inflation will essentially be underpinned by (i) the remaining global supply chain disruptions fading away, (ii) the gradual impact on demand of monetary policy tightening and (iii) the recent energy cost declines progressively passing through (with something of a lag) to the prices of other goods and services. As a result, annual average inflation will stand at 2.2% in 2024 and 1.8% in 2025.

In any event, these projections rest on two critical assumptions. First, it is assumed that the pass-through of past cost increases is near completion, and that the pass-through of the recent declines will come to the fore over the coming months. Second, in line with the evidence available to date, it is assumed that no significant second-round effects that might trigger feedback loops between the current inflationary pressures will emerge over the projection horizon.

As compared with those published three months ago, the current projections revise up both underlying and food inflation in 2023, but also include a significant downward correction of headline inflation. The higher growth in food prices and underlying inflation anticipated in 2023 largely owes to the recent upside surprises in these categories, which are only partially offset by the more moderate increases in their future prices. However, the significant reduction in energy prices during recent months (sharper than anticipated in the December projections), coupled with a higher exchange rate, has prompted a very substantial adjustment to the energy component in 2023, which more than offsets the additional inflationary pressures stemming from the underlying and food components. The projected inflation rates for 2024 and 2025 (both headline and underlying) differ only slightly from those forecast in December (see Chart 4.a).

Risks

In the current context of heightened uncertainty, the risks surrounding the materialisation of the activity and inflation scenario described above are very pronounced, being tilted to the downside in terms of economic activity and balanced in terms of inflation. Just over a year since the Russian invasion of Ukraine, geopolitical uncertainty remains very high. As a result, energy prices may follow very different trajectories to the one envisaged in the baseline scenario of these projections, which, as is standard practice, is grounded on current energy commodity prices on the futures markets. In the case of gas, price uncertainty is further exacerbated by the difficulty in estimating how China's economic reopening will affect the country's purchases of liquefied natural gas. In any event, European gas demand declined over the course of this winter, drastically reducing the risk of gas supply restrictions in the main European economies in the near term.

In addition to these future energy price uncertainties, the pass-through of past energy price movements to consumer prices in the coming quarters can only be estimated vaguely. There is evidence that the rise in the HICP energy component between early 2021 and mid-2022 has fed through to the prices of other goods and services in the consumption basket more robustly (in average terms) than has been observed in recent decades.[8] However, how much of the pass-through is yet to take place is subject to much uncertainty. The recent downward stickiness of underlying inflation and EBAE data seem to suggest that firms are still passing some of the cost increases observed up to mid-2022 through to their selling prices. Further, the interplay between this incomplete pass-through and the more recent price declines across numerous commodities, energy and non-energy alike, is hard to pinpoint.

The pace at which inflation eases (in itself highly uncertain) will shape the course of other key and closely interconnected macro-financial variables. These include the strength of demand (since inflation influences households' and firms' purchasing power), the probability of a price-wage feedback loop emerging (the more persistent the current inflationary episode, the higher the probability), and the degree of monetary policy tightening that is required (whose impact on the financial vulnerability of households and firms, on their spending and investment decisions, and on overall aggregate demand is also highly uncertain. This latter aspect has recently come to the fore amid the episode of acute financial tensions. These were prompted by the concern across international capital markets regarding the robustness of some financial institutions, against a backdrop in which, in the last few quarters and from a historical viewpoint, interest rates have been rising very sharply and swiftly, and in a synchronised fashion around the world. It is impossible to accurately predict whether, in the most immediate future, these financial tensions will persist or, conversely, will gradually ease. In any event, it seems likely that the uncertainty that has already emerged regarding the robustness of the international financial system will have a somewhat adverse bearing on economic activity over the coming quarters and will contribute to weakening the inflationary dynamic.

There are also others sources of uncertainty, both in the external environment and at the domestic level. For instance, in the international arena, as has been mentioned, it is unclear how the reopening of the Chinese economy will affect activity and inflation in other countries, such as Spain. On the purely domestic front, there is continued uncertainty over, for example, how the savings built up by households during the pandemic might contribute to private consumption, the pace at which the NGEU projects will be rolled out and their capacity to boost the economy's potential growth.

8 José González Mínguez, Samuel Hurtado, Danilo Leiva-León and Alberto Urtasun. (2023). "The spread of inflation from energy to other components". *Economic Bulletin - Banco de España,* 2023/Q1, 02. https://doi.org/10.53479/25119.

Annex 1
Assumptions underlying the projections

In comparison with the December projections, the most notable changes in the technical assumptions used as a starting point for the projection exercise affect energy prices (lower now for oil and gas), short and long-term interest rates (both now higher), and the growth rate of export markets (revised upwards for 2023, partly as a result of the upside surprises in global economic activity in the final stretch of 2022). The euro exchange rate is slightly higher than in the previous projection exercise (see Table 2).

The fiscal assumptions factor in a somewhat more negative Spanish general government balance at end-2022 than that anticipated in December, owing to the recent, significant slowdown in revenue from indirect taxes and to the greater-than-expected buoyancy of government consumption towards the end of last year.

As for 2023, the package of measures approved on 27 December 2022[9] to mitigate the impact of the energy crisis extended some of the measures implemented last year into 2023 and also introduced new ones, entailing an overall estimated budgetary cost of 0.6 pp of GDP in 2023.[10] Since the assumptions of the December projection exercise already factored in most of these measures (energy tax cuts, increase in the minimum living income and in non-contributory pensions, and public transport subsidies), new measures are limited to VAT cuts on food items, the one-off subsidy for vulnerable households and fresh subsidies for hauliers and firms, accounting for around 0.2 pp of GDP overall. It is assumed that all the measures contained in Royal Decree-Law 20/2022 will remain in force for the officially approved term (further extensions are not envisaged), so none of the above measures would be in force in 2024 or 2025.

Meanwhile, a series of measures to boost receipts will come into force in 2023. These include new social security contributions under the “intergenerational equity mechanism”, temporary taxes on energy utilities and financial corporations, the temporary solidarity wealth tax, and various tax changes included in the 2023 State Budget Law. Together, these measures – which the December projection exercise had already taken into account – represent around 0.5 pp of GDP in higher tax revenues, although the bulk of these (some 0.4 pp) are temporary and would likely disappear in 2025.

Over the rest of the horizon, the projections continue to assume some correction of the dramatic rise in the government revenue-to-GDP ratio since the outbreak of the COVID-19 pandemic, and also factor in the increase in defence spending announced by the Government. Otherwise, the projections are based on the usual technical assumptions. More discretionary spending items (such as procurement) are expected to evolve in line with the growth potential of the Spanish economy. Government investment and capital transfers paid will essentially be determined by the assumptions made with respect to the roll-out of NGEU and the announced increase in defence

9 See Royal Decree-Law 20/2022.

10 The measures under Royal Decree-Law 20/2022 whose impact falls in 2022 have a further budgetary cost of 0.2 pp.

spending. Further, tax revenue will grow in line with the tax bases while pension expenditure, unemployment benefits and interest payments will be shaped by the usual determinants.[11]

Overall, once the impact of the European funds is taken into account, the fiscal policy stance in 2023, measured by the change in the primary structural balance, is expected to be slightly expansionary.[12] This would be attributable to the increase in pension expenditure and higher investment funded by NGEU, which would amply offset the impact of the new taxes and the withdrawal of some of the temporary spending measures, such as the blanket discount on fuel prices or the COVID-19-related measures still in force. The withdrawal, assumed to take place in 2024, of the support measures deployed in response to the rise in energy prices would foreseeably entail a contractionary fiscal impulse in that year. However, that impulse would turn clearly expansionary in 2025, when, in addition to the structural increase in spending (mainly on account of pensions) and the fall in receipts (owing to the partial reversal of the upside surprises in tax revenues in 2020-2022), the temporary taxes introduced in 2023 are expected to be cancelled.

11 Pension expenditure is determined by demographic trends and by the indexation of pensions to the CPI, unemployment benefits depend on unemployment numbers and interest payments are shaped by government debt, interest rates and the cost of inflation-linked bonds.

12 The Recovery, Transformation and Resilience Plan funds do not affect the Spanish budget deficit, as they allow for a higher level of spending without the corresponding funds needing to be sourced from resident agents. As a result, they entail an expansionary impulse that does not result in a change in the structural balance.