BBVA Research

Creating Opportunities

Spain Economic Outlook

December 2022

Situation and outlook for the Spanish Economy in Q422

December 2022

The forecast for GDP growth in 2022 and 2023 is revised slightly upward to 4.6% and 1.2%, respectively. The economy is holding up better than expected and to some extent reduces the probability of a contraction in activity. Private consumption and exports continue to increase demand, although higher imports are diluting a significant part of the momentum. The labor reform is contributing to a different behavior of employment, although there are doubts about what this implies for the total number of hours worked and effective unemployment. Inflation will be lower than expected three months ago, mainly because of the sharp drop in electricity and fuel prices. Wages continue to show a contained behavior, consistent with a reduction in inflation over the coming months. The current account remains in surplus, thanks to the reduction in the public deficit and the strength of the services trade balance.

GDP growth in the third quarter of 2022 was in line with BBVA Research's forecast. Production was expected to stagnate compared to the previous quarter (0.0% quarter-on-quarter), somewhat below the preliminary forecast of the INE (0.2%). In any case, domestic demand contributed more to growth than expected. For example, private consumption increased, funded by wealth amassed by households since 2020, despite the possible slowdown in their disposable income and the loss of purchasing power. Investment in machinery and equipment also grew, boosted by the easing of restrictions that have benefited the automotive sector. Finally, sales of goods abroad showed a positive performance, especially considering that the slowdown in the eurozone is widespread. In contrast, the components that unexpectedly limited GDP growth were non-resident consumption and the fact that a large part of the increase in private sector spending concentrated in imports.

Nowcasts of fourth-quarter growth show the economy holding up better than expected. If current trends are confirmed, GDP would practically stagnate or could experience an increase similar to that of the previous quarter, as compared to the moderate decline (-0.3%) expected two months ago. Although confidence indicators are worse, activity data remain resilient. Employment is performing atypically positively in the final part of the year. The behavior of Social Security affiliation and registered unemployment in October and November is consistent with GDP growth in the fourth quarter if the relationship between the two variables holds as it was before the entry into force of the latest labor reform. However, there are doubts about the endurance of this relationship. Many people have moved to a state in which, even with agreement, they do not work, waiting for the seasonal recovery of demand in the services sector. Discontinuous permanent contracts allow for this situation, while maintaining the employment relationship with the employer. These structural changes are difficult to measure in real time, but the relationship between employment and activity has changed with the reform and, therefore, under this perspective, a practical stagnation of GDP in the fourth quarter of the year is more likely than growth.

As a result of the improved performance of the economy, growth forecasts for 2022 and 2023 are revised upwards (0.2 percentage points in each year to 4.6% and 1.2%, respectively), although a contraction in activity remains possible in the coming months. The current slowdown and the fall in GDP expected at the beginning of next year are the result of several factors that will reduce the contribution of external demand and household consumption compared to their role in the recovery period.

The eurozone's entry into recession, together with the exhaustion of the recovery in the tourism sector, will cause the contribution to external demand growth to turn negative in 2023 and 2024. The continent is facing a winter with higher energy costs. In addition, inflation is still rising in many countries, with no sign of a turnaround. In part, this reflects the delay in establishing mechanisms to limit the impact of higher gas prices on electricity prices. The result increases uncertainty for European households and businesses, a loss of purchasing power of wages while margins are squeezed, and a rapid and significant increase in interest rates by the European Central Bank (ECB). With regard to the latter, 12-month euribor is expected to continue to rise and stabilize at around 3% at the beginning of next year, some 350 basis points higher than at the beginning of 2022. All the above foreshadows a reduction in activity in the eurozone in the fourth quarter of this year and the first quarter of next year. In fact, EMU GDP is expected to show relative stagnation over the next year (-0.1%). It is therefore to be expected that demand for Spanish goods and services from the rest of Europe will decline. To this we must add the likely exhaustion of the boost provided by the lifting of restrictions associated with the pandemic, which will affect the performance of the services sector.

Spanish household expenditure will be hurt by increased uncertainty, rising prices, a slowdown in employment and higher interest rates. As in the eurozone, private consumption will show the exhaustion of the easing of restrictions on opening hours and capacity in the services sector. More importantly, inflation has reduced the purchasing power of wages. The slowdown in employment (1.1% in 2023, down from 3.3% in 2022) and hours worked will lead to a decline in household disposable income, in real terms, of almost 8% (between September 2021 and March 2023). The increase in prices will also contract the purchasing power of household wealth, both financial and real estate, which will also adversely affect willingness to consume in the coming months. Likewise, the update of mortgage installments will bring increases in the amount of resources allocated to interest payments. This will particularly affect spending at the end of the year and the beginning of the following year, when the effect on consumption could be around one percentage point. To all the above, we must add the uncertainty related to the geopolitical context and, going forward, to economic policy as the electoral cycle progresses.

The economy will improve as some of the uncertainties affecting households and businesses melt away, boosting GDP growth in 2024 to 3.4%. Efforts made so far suggest that a gas rationing scenario is becoming less and less likely. Suppliers have diversified, inventories have accumulated and consumption in the eurozone as a whole has declined. In this context, gas prices have reversed much of the increase seen during the second and third quarters of the year. Current levels are expected to consolidate, if temperatures remain in line with those of a normal winter in Europe and in the absence of additional geopolitical tensions. Looking ahead to 2024, as efforts to become more efficient continue and investment in the sector begins to increase the supply of alternative sources more decisively, the price could continue to decline toward pre-invasion levels. In any case, this would give way to a scenario with greater certainty on the cost and supply of energy.

The fall in overall inflation will continue over the coming quarters, although reducing the trend in core inflation will be more difficult. The Consumer Price Index (CPI) is expected to increase, on average, by 4.0% in 2023 and 2.8% in 2024, after increasing by 8.5% in 2022. In addition to the reduction in the price of gas, we must add the impact that the decrease in the cost of fuel can have on business competitiveness. However, there are signs of improvement in the restrictions that were hindering the availability of intermediate goods. Bottlenecks in production chains are easing and, as a result, the prices of some goods may begin to fall. To this we can add the impact that the slowdown in demand will have on price formation. Sectors particularly affected by the rebound in interest rates, such as housing and durable goods, may show larger adjustments. It is also to be expected that part of the increase seen in the value of tourism services will be reversed, as the sector faces a less favorable environment due to the fall in disposable income of European households and greater competition from alternative destinations as confidence in traveling outside the continent increases.

Motor vehicle production is starting to recover and may give positive surprises over the next few years. Automobile sales have suffered since 2019 from a series of adverse events, including tax changes, regulatory uncertainty, doubts around the purchase of electric vehicles, the pandemic, the rise of work-from-home and competition from alternative modes of transportation. In any case, the greatest constraint to recovering the business levels of a few years ago is the lack of vehicle availability as a consequence of the bottlenecks affecting the supply of certain inputs. However, there is evidence of an incipient recovery in supply: in August and September, production in Spain has returned to 2019 levels, after averaging 25% lower levels in the first seven months of the year. For their part, sales have gone from falling back by 40% compared to 2019 records to doing so by 25%. If it is confirmed that there is an uninterrupted flow of trade back into the sector, pent-up demand may begin to surface as supply increases. Passenger car registrations could increase by 10% to 25% in 2023.

Businesses and households are better prepared to face a more volatile environment. Historically, the Spanish economy has entered crisis after accumulating imbalances that have led to an increase in external indebtedness. Additionally, with each episode of rising oil prices, the current account has gone into deficit. However, on this occasion, it shows a surplus (1.0% of GDP in 2022) and prolongs the deleveraging process vis-à-vis the rest of the world. This is even though the trade balance of goods has worsened as a result of the increase in the cost of imported energy. The continued recovery in this environment has been possible thanks to the exceptional performance of the services sector, mainly tourism, which has allowed the economy to generate more than enough income to offset energy costs.

Savings accumulated during the pandemic will enable some households to continue consumption or invest. The increase in wealth caused by the impossibility of spending on leisure, catering, transportation and accommodation may have reached €130 billion by mid-2022. These resources will offset part of the loss of purchasing power resulting from higher inflation. The same applies to the increase in interest rates. In fact, there is a rebound in mortgage repayments, which will help to reduce the impact of the rise in the cost of money. Added to this is the increase in the share of fixed-rate loans (reaching 30% of the total outstanding mortgage balance) and the considerable deleveraging effort over the past 14 years.

In addition, no significant sectoral imbalances were detected. There has not been a process of overinvestment with an increase in indebtedness. The strength of the real estate sector stands out. On the one hand, there is no oversupply that could cause prices to enter a vicious cycle that could indefinitely reduce the value of collateral. In fact, what is anomalous is the lack of response of new housing starts to the strong behavior of demand. Moreover, banks have improved their level of capital and their approach to the sector, while regulators have emphasized measures to prevent excessive risk-taking. In this context, housing prices do not deviate from the fundamentals that traditionally explain them and will fall in real terms (-3.2% and -2.4% in 2022 and 2023, respectively) due to the cooling of demand and the increase in inflation. In any case, in nominal terms it will continue to grow if household income continues to grow and there is still latent demand due to the relative increase in income.

The public sector continues to reduce the deficit, which, if it continues to perform as it has so far this year, could even end the year below 4% of GDP. As the ECB prepares to shrink its balance sheet, the balance of government accounts could approach the pre-pandemic level. This consolidation has also helped to avoid additional imbalances. In addition, the Treasury has done a respectable job of lengthening the maturity of debt, so the increase in interest payments will be gradual and will not constrain fiscal policy in the short term. The government has announced a range of taxes on the energy sector, banking and wealth, which should help finance some of the policies designed to limit the costs of the crisis, especially for lower-income households. This, together with the suspension of fiscal rules next year, allows for moderate fiscal leeway that can be used in the event of a further decline in economic activity.

Fiscal policy will continue to be expansionary over the next two years thanks to transfers received on account of NextGenerationEU (NGEU) funds. In fact, in the absence of the government expenditure effort projected for 2023, GDP would be closer to contraction than to moderate growth. During 2022 and up to the end of September, the central government has authorized (approved and implemented) spending programs linked to the Recovery, Transformation and Resilience Plan (Spanish 'PRTR') in the amount of €21.6 billion, 75% of the total planned for this year. Two thirds of these projects are investments related to the green transition and sustainable transportation and mobility; 25% of the total will be managed by the autonomous communities (devolved regions of Spain). This effort should result in a positive behavior of investment in the coming months, independently of the overall uncertainty affecting the Spanish economy.

The factors that could make the scenario worse than as presented here remain in the majority, however. The loss of competitiveness and purchasing power could spread if there is a further worsening in the geopolitical situation. The rise in COVID cases in China and an eventual return to total lockdown may jeopardize the availability of inputs, the smooth functioning of value chains and falling costs. Even without these events, inflation may remain high due to the impact of collective bargaining over the coming months. The rise in prices is widespread, suggesting that businesses are trying to recover some of their lost profitability. Wages are increasing at a higher rate than in the years prior to the pandemic, although without recovering the purchasing power they had. In this context, the consolidation of the so-called 'income pact' will be key to the future behavior of inflation. The extension of the limit on the increase in rental prices does not go in the right direction, as it determines arbitrarily, without any reference to how other rents evolve, how tenancies should be updated. Nor does the creation of special levies on large companies or banks seem appropriate. The announcement to limit to 50% the possibility of offsetting the losses of subsidiaries in consolidated groups may have adverse effects on investment and job creation. Large companies make up about 0.2% of the total, but account for 35% of employment. In addition, the measure may intensify job destruction in an environment of falling demand, as companies may decide to reduce the workforce to avoid making losses, given the possibility of not receiving a tax benefit. In addition, it may harm companies that are already in a negative situation, reinforcing vicious circles. Finally, and given the possibility that the measure may be permanent, or be perceived as such, it may change decisions on new investments, with projects shifting to other countries.

The introduction of a specific levy on banking disregards the fact that since 2013 the sector's profitability has not only been lower, but also more volatile than that of the rest of the economy. In addition, it is not designed to capture 'windfall profits.' The return on equity (ROE) of deposit institutions (the perimeter in Spain within which the tax will fall) has continued to lag the profitability of large Spanish companies of comparable size. According to the Bank of Spain, the average return on equity of the banking system in 2019 was 6.9% compared to 10.7% for companies with more than 250 employees. In 2020, COVID restrictions led to losses in banking, with an ROE of -0.7%, compared to 7.2% for large companies. The latest data published by the Bank of Spain for the second quarter of 2022 point to an ROE of 8%, compared to more than 12% projected for large companies. Moreover, the new banking tax is not even designed to tax hypothetical windfall profits (which, like the rest, would already be subject to corporate income tax at an interest rate of 30% as opposed to the general rate of 25%), but the main component of income: net interest income plus net fees and commissions. On the one hand, this taxable base does not consider operating costs and the cost of new regulatory requirements, investments in technology or the provisions required in a context of slowdown. On the other, this margin has not recovered to its pre-pandemic level (in real terms, until the second quarter of 2022), which calls into question its being a 'windfall.'

A tax reform is needed to reduce distortions in consumption and investment, in addition to providing certainty on the sustainability of government finances. While it is true that there has been a reduction in the fiscal deficit, the reversal of the imbalance toward levels like those of 2019 occurs with revenue and expenditure that exceed GDP by 5 and 6 pp, respectively, those observed then. Regarding revenue, there are reasonable

doubts as to how much of the increase may be temporary and how much structural. In any case, this has led to an increase in the tax burden, especially on companies. Going forward, it is necessary to assess whether this composition of revenue is efficient, promotes growth in investment, employment and financing, maximizes revenue and meets the policy objectives of redistribution and environmental sustainability. With respect to spending, it is imperative that we examine its increase and determine whether it is consistent with the changes that have occurred in the demand for public services, the protection of groups vulnerable to the pandemic, and the increase in the price of energy. As the emergency subsides, spending should also decrease. Finally, it is of utmost importance to provide certainty on the behavior of the deficit after 2024. In a situation without additional measures, it is possible that, even in a recovery environment, the deficit will increase again. In addition, there are as yet no definitive answers to the imbalances that will arise from population aging in the coming years. As the ECB shrinks its balance sheet, the pressure on interest payments will grow. This will raise concerns about public finances.

In the absence of an acceleration in awards of NGEU funds, the economy could experience a sharper correction. Public spending is expected to act as a counterweight to the fall in private investment because of the factors mentioned above. In the absence of an evaluation of whether there have been failures in the allocation of resources, it is necessary to try to improve the information received by the private sector on the entire process. It would be advisable for the Government to accelerate its commitment to transparency in the disbursement of the funds. Incomplete information that is becoming available suggests that, although project bidding gained traction in the second and third quarters of the year, it has slowed down during the last few months. More importantly, awards (around €7 billion) remain well below what has been tendered for so far (€22 billion). If information does not flow, companies (especially SMEs) will continue to complain about the lack of traction of the funds in most of the productive fabric.

The behavior of profit margins, labor costs and the lack of human capital may restrict the capacity for job creation in the coming years. As mentioned earlier, it is crucial to advance in the negotiation of an 'income pact.' This must be transparent and must convey the need for all social agents to assume a cost. The increase in the price of energy has made the Spanish economy poorer. Employers and workers, pensioners and taxpayers, savers and debtors must all bear part of the cost. In the absence of agreement and acceptance of the loss of purchasing power by the vast majority, there may be sources of social stress if any group feels particularly affected by the status quo. On the other hand, the behavior of wages over the next few years will be uneven, reflecting the lack of qualified personnel in the Spanish labor market. Unfilled vacancies are increasing, with unemployment levels still high. The next employment challenge should be to reduce the structural unemployment rate. To this end, a review of employee training strategy is necessary. In addition, an evaluation of the effectiveness of passive policies to increase their protection during recessionary periods, but also to encourage their return to employment during expansion, is critical.

The likelihood is growing of an even tougher monetary response from the ECB to the pickup in inflation. In contrast to what is happening in Spain, inflation in the eurozone continues to rise. The monetary authority has warned of the need to bring interest rates to levels that will restrain the behavior of spending and help consolidate expectations of price behavior. Unlike in the United States, in Europe most of the increase in inflation is driven by supply factors rather than demand. As the rise in energy prices has been halted or even reversed, CPI inflation will moderate in the coming months. The recession expected at the end of 2022 and beginning of 2023 will help to contain the pass-through of the increase in costs to prices. In addition, monetary policy is acting with a lag and the effects of the increases in the cost of money over the last few months will only just begin to be felt. These factors point to the need for the ECB to enter a waiting period once interest rate levels between 2.5% and 3% are reached. The risk here is that there is a desire to accelerate convergence to the target at the cost of triggering a deeper recession, or this may be the outcome if the effects of a tighter monetary policy are not properly calibrated.

There are doubts about the performance of the tourism sector, given the observed loss of competitiveness and the expected decline in demand due to the fall in household income and changes in consumption habits. Accommodation prices in Spain are 5.3% higher than those recorded in 2019. This reflects, on one hand, an increase in spending on services because of the easing of restrictions and the rebound after the pandemic. On the other hand, this is a widespread process in the rest of the countries that are direct competitors in the sector: while it is estimated that accommodation prices would be 6% overvalued in Spain, other destinations such as Croatia (23%), Portugal (19%) or Greece (9%) would show even higher levels of deviation from equilibrium. Looking ahead, the sector faces a scenario in which, after recovering pre-pandemic occupancy levels, the loss of household purchasing power in Europe may lead to a drop in demand. In addition, the effect of vaccination on demand for tourism services will diminish, while higher-income households will tend to travel again to destinations outside the EMU. All this may lead to a tightening in the sector's margins over the coming months, the intensity of which is still uncertain.

Tables

Table 1.1. **GROSS DOMESTIC PRODUCT** (ANNUAL AVERAGE, %)

	2020	2021	2022	2023	2024
United States	-2.8	3.7	1.9	0.5	1.8
Eurozone	-6.3	5.3	3.2	-0.1	2.0
China	2.2	8.1	3.6	5.0	5.0
World	-2.9	6.3	3.3	2.3	3.3

* Argentina, Brazil, Chile, Colombia, México, Paraguay, Perú and Uruguay.
Forecast closing date: November 30, 2022.
Source: BBVA Research & FMI.

Table 1.2. **INFLATION** (ANNUAL AVERAGE, %)

	2020	2021	2022	2023	2024
United States	1.2	4.7	8.0	4.1	2.7
Eurozone	0.3	2.6	8.5	6.0	1.9
China	2.5	0.9	2.3	2.5	2.0
World	3.1	4.5	7.8	5.6	4.3

* Argentina, Brazil, Chile, Colombia, México, Paraguay, Perú and Uruguay.
Forecast closing date: November 30, 2022.
Source: BBVA Research & FMI.

Table 1.3. **INTEREST RATE ON TEN-YEAR PUBLIC DEBT** (ANNUAL AVERAGE, %)

	2020	2021	2022	2023	2024
United States	0.90	1.44	3.03	4.46	4.18
Germany	-0.48	-0.31	1.21	2.30	2.34

Forecast closing date: November 30, 2022.
Source: BBVA Research & FMI

Table 1.4. **EXCHANGE RATES** (ANNUAL AVERAGE)

	2020	2021	2022	2023	2024
EUR-USD	0.88	0.84	0.96	0.98	0.90
USD-EUR	1.14	1.18	1.05	1.02	1.11
CNY-USD	6.91	6.45	6.73	7.01	6.80

Forecast closing date: November 30, 2022.
Source: BBVA Research & FMI.

Table 1.5. **OFFICIAL INTEREST RATES** (END OF PERIOD, %)

	2020	2021	2022	2023	2024
United States	0.25	0.25	4.50	4.75	3.25
Eurozone	0.00	0.00	2.50	2.75	2.50
China	4.35	4.35	3.60	3.60	3.60

Forecast closing date: November 30, 2022.
Source: BBVA Research & FMI.

Table 1.6. **EMU: MACROECONOMIC FORECASTS** (YoY) (ANNUAL AVERAGE, %)

	2020	2021	2022	2023	2024
GDP at constant prices	**-6.3**	**5.3**	**3.2**	**-0.1**	**2.0**
Private consumption	-7.8	3.7	3.7	0.1	2.0
Public consumption	1.0	4.3	1.9	1.0	0.4
Gross fixed capital formation	-6.5	3.7	2.6	0.8	3.8
Inventories (*)	-0.3	0.2	0.2	0.0	0.0
Domestic demand (*)	**-5.7**	**4.0**	**3.1**	**0.4**	**1.9**
Exports (goods and services)	-9.2	10.5	6.6	1.3	3.5
Imports (goods and services)	-8.7	8.3	6.9	2.5	3.7
External demand (*)	**-0.5**	**1.3**	**0.1**	**-0.5**	**0.0**
Prices and Costs					
CPI	0.3	2.6	8.5	6.0	1.9
CPI Core	0.7	1.5	3.9	4.3	2.8
Labour Market					
Employment	-1.5	1.4	2.1	-0.1	0.3
Unemployment rate (% of labour force)	8.0	7.7	6.8	7.4	7.4
Public sector					
Surplus (+) / Deficit (-) (% GDP)*	-7.0	-5.1	-4.0	-3.8	-3.4
Public debt (% GDP)*	97.0	95.4	93.7	95.1	95.2
External Sector					
Current Account Balance (% GDP)	1.6	2.3	0.0	-0.3	0.8

Annual rate change in %, unless expressly indicated.
Forecast closing date: November 30, 2022.
(*) Excluding financial aid for Spanish banks.
Source: BBVA Research.

Table 1.7. **SPAIN: MACROECONOMIC FORECASTS**
(ANNUAL RATES OF CHANGE IN %, UNLESS OTHERWISE INDICATED)

(Annual average, %)	2020	2021	2022	2023	2024
Activity					
Real GDP	**-11.3**	**5.5**	**4.6**	**1.2**	**3.4**
Private Consumption	-12.2	6.0	2.0	0.9	2.8
Public Consumption	3.5	2.9	-1.7	1.5	1.9
Gross Fixed Capital Formation	-9.7	0.9	5.2	5.3	11.3
Equipment and machinery	-13.3	6.3	6.1	4.2	11.2
Construction	-10.2	-3.7	4.1	4.9	12.0
Housing	-11.4	-4.8	2.6	1.4	11.3
Domestic Demand (contribution to growth)	**-9.1**	**5.2**	**1.5**	**1.9**	**4.3**
Exports	-19.9	14.4	17.3	-0.2	4.8
Imports	-14.9	13.9	8.8	1.6	7.7
External Demand (contribution to growth)	**-2.2**	**0.3**	**3.1**	**-0.7**	**-0.9**
GDP at current prices	-10.2	7.9	7.9	3.8	4.8
(Billions of Euros)	1118.0	1206.8	1301.8	1350.6	1415.5
Labour market					
Employment, Labour Force Survey	-2.9	3.0	3.3	1.1	2.8
Unemployment rate (% Labour force)	15.5	14.8	12.8	12.8	11.3
Employment, full time equivalent	-6.8	6.6	3.9	1.1	2.7
Productivity	-4.5	-1.1	0.7	0.1	0.7
Prices and Costs					
CPI (average)	-0.3	3.1	8.5	4.0	2.8
CPI (end of period)	-0.5	5.8	7.0	4.0	2.6
GDP deflator	1.1	2.4	3.3	2.6	1.4
Compensation per employee	2.5	-0.8	1.3	3.8	4.2
Unit Labour Cost (ULC)	7.0	0.3	0.6	3.7	3.5
External sector (*)					
Current Account Balance (% GDP)	0.4	0.9	1.0	-0.9	-2.5
Public sector					
Debt (% GDP)	120.4	118.3	113.6	113.4	111.3
Deficit (% GDP) (*)	-9.9	-6.8	-3.9	-4.0	-3.0
Households					
Nominal disposable income	-2.0	3.1	4.6	4.7	5.0
Savings rate (% nominal disposable income)	17.6	13.7	8.2	7.6	6.8

Annual rate change in %, unless expressly indicated.
Forecast closing date: November 30, 2022.
(*) Excluding financial aid for Spanish banks.
Source: BBVA Research.

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