CIO Special

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Spain: lower GDP growth in 2024

Key messages

- The Spanish economy will close 2023 with growth close to 2.5%, thanks to the strength of domestic demand, especially during the first half of the year.
- The indicators available for the last months of 2023 point to a marked slowdown, due to the cumulative impact on domestic demand of the rise in interest rates and the weakness of our external partners. The Spanish economy is expected to grow by 1.4% in 2024.
- 2024 will bring a return to European fiscal rules, in a complex political environment, where the support of regional parties for the government will be key. Despite this, we expect the Spanish risk premia to remain stable at around current levels.

01 2023: Higher growth than expected

With one month to go before the year end, the Spanish economy is on track to close 2023 with GDP growth of 2.5%, higher than expected. This is thanks to a surprising first half of the year, and a third quarter which, although weaker, showed growth of 0.3% quarter-on-quarter (QoQ) (1.8% YoY)[1], above the European average. According to the latest revision of the historical series carried out by Spanish Statistical Office (INE) [2] a few weeks ago, the Spanish economy would have surpassed the pre-pandemic level in the third quarter of 2022 and would be 2% above that level in the second quarter of 2023.

There are several reasons for the economy's better performance this year compared with its European neighbours. The main one is the favorable evolution of consumption, supported by wage rises and the good performance of employment. According to the latest Labour Survey (EPA), employment grew by 1% in the third quarter of 2023, although it lost some momentum compared with the first months of the year due to the slowdown in economic growth. The figures available for October and the first half of November suggest that this slowdown will continue at the end of the year. All in all, the unemployment rate will end the year below 12%, a historically low figure. The sharp drop in the temporary employment rate that occurred in 2022 seems to be stabilised during 2023 at around 17% according to the EPA, and between 14% and 15% according to Social Security enrolment data, figures much closer to the European average (13.5%).

The favourable evolution of employment, the improvement in wages and the growth in public pensions (+8% annual increase in 2023) have offset the increase in the financial burden on households derived from the accumulated interest rate hikes by the ECB. This has led to an increase of more than 10% in households' gross disposable income. The savings rate, which during 2022 decreased below pre-pandemic levels in the face of the energy shock, would have recovered during H1 2023 to return to above 10%.[3] A large part of this saving has been used by Spanish households to pay off debt, favouring the deleveraging process of the private sector. At the end of Q3 2023 Spanish household debt stood at 49.9% of gross disposable income, the lowest figure in 20 years.

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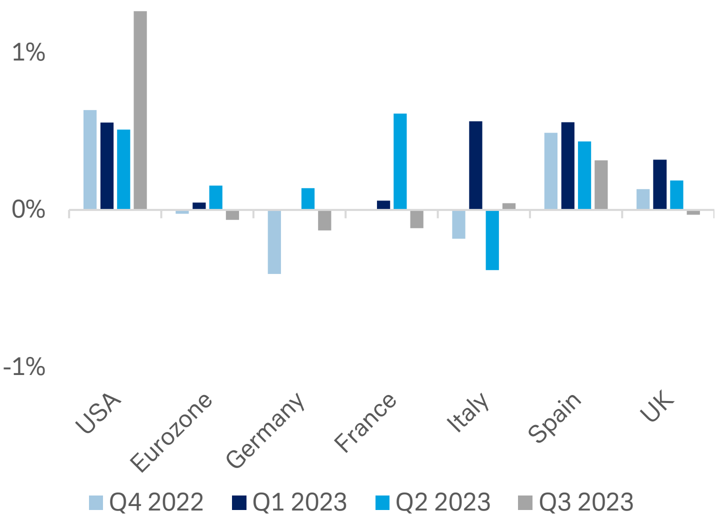
Figure 1: GDP growth individual countries (%, YoY)



Source: Bloomberg Finance L.P., Deutsche Bank AG. Data as of November 30, 2023.

At the other end of the spectrum has been the evolution of credit. According to the Bank of Spain's latest Financial Stability Report,[4] the accumulated rises in interest rates have taken their toll on the demand for credit. As a result. the weakness of the real estate sector has been accentuated since Q3 2023. At the end of that quarter, the volume of housing sales fell by 15% YoY, while mortgage lending for house purchases declined by 26%. Nevertheless, both magnitudes remain above pre-pandemic levels. The shortage of supply due to high production costs (lack of land, increase in the prices of construction materials, rising labour costs) and the strong demand for housing (strong influx of foreigners and increased demand for housing by the children of baby boomers) continue to keep prices up.

On the other hand, if we look at the supply of credit, since the beginning of 2022, Spanish banks have tightened the lending criteria in all segments.

Our external sector has seen some weaknesses as our main trading partners, especially Germany, have been faced with low growth rates. On the positive side, however, the normalization of tourism stands out, which has more than recovered the highs reached before the pandemic.

In fact, the greater strength of the Spanish economy in 2023 vs. European peers may be partly justified by the greater weight of tourism-related services in the economy (11.4% of GDP, compared with 7.3% in the euro area). Meanwhile, the weight of manufacturing sector is lower in Spain than in the Eurozone as a whole (12% vs. 16.5%, respectively), which means that, although they have been affected by global supply problems or the weakness of China, they have been affected to a lesser extent than other countries (such as Germany).

02 Prospects 2024: a year of less to more

As mentioned, the indicators available for the last few months of the year point to a marked slowdown in activity, as a result of the cumulative impact of the rise in interest rates, which is holding back consumption and investment, and the cooling of the rest of Europe, which is weighing on the external sector. Looking ahead, the majority of activity data shows that this weakness will continue. The moderation of inflation figures leads us to expect lower wage growth, while many of the fiscal measures established in 2022 to mitigate the negative effect of the energy shock will disappear. The upcoming reactivation of European fiscal rules will weigh on public spending, although public investment could maintain its positive growth thanks to the development of NextGen funds.

Nevertheless, the Spanish economy will continue to expand faster than the European average (CIO Spain's GDP growth forecast: +1.4% in 2024 vs +0.7% expected for the Eurozone).

GDP growth is expected to ease over the course of the year, in line with expectations of the start of a phase of interest rate cuts by the ECB in mid-2024. According to our estimates, the ECB could cut rates up to 75bps in 2024, leaving the deposit facility interest rate at 3.25% and the refinancing interest rate at 3.75%.

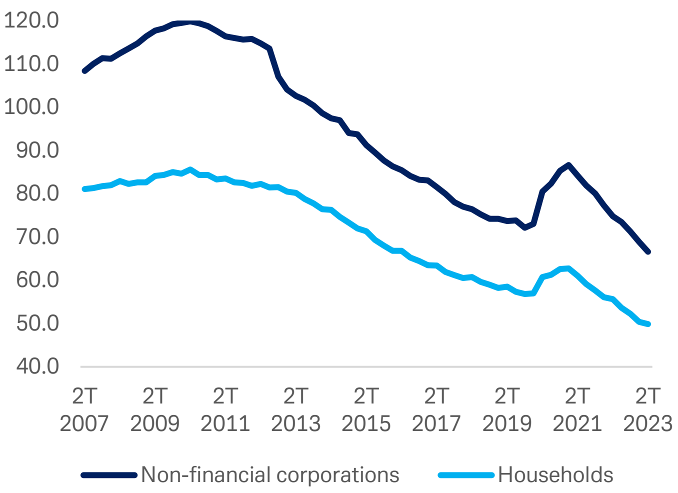
As for inflation, weakening domestic demand should continue to support a gradual easing of prices, although at year-end inflation will still be far from the 2% target (according to the European Commission's latest estimates,[5] headline inflation will stand at 3.6% on average in 2024). This slow pace of price reductions is justified, on the one hand, by the withdrawal of some of the containment measures (VAT reductions) established by the government in 2022 to alleviate the energy crisis, and on the other, by the traditional asymmetry in price adjustments observed in the Spanish economy historically, which usually entails a slower downward than upward adjustment in the services sector, which is relatively little exposed to competition.

Figure 2: Spain: forecast summary

		Bank of Spain	OECD	European Commission
GDP (%, YoY)	2023	2.3%	2.5%	2.4%
	2024	1.8%	1.5%	1.7%
	2025	2.0%		2.0%
HICP (%, YoY)	2023	3.6%	3.5%	3.6%
	2024	4.3%	3.7%	3.4%
	2025	1.8%		2.1%
Fiscal deficit (%GDP)	2023	-3.7%	-3.8%	-4.1%
	2024	-3.4%	-3.5%	-3.2%
	2025	-4.1%		-3.4%
Government debt (%GDP)	2023	108.8%	109.4%	107.5%
	2024	106.9%	110.0%	106.5%
	2025	107.9%		106.5%

Source: Bank of Spain, OECD, European Commission.[6,7] Data as of October 2023.

Figure 3: Evolution of private sector debt (as % of GDP)



Source: Bank of Spain. Data as of June 30, 2023.

Moreover, everything points to energy prices remaining high next year. According to our estimates, the price of Brent could close 2024 at 88 USD/bd as a result of OPEC's supply control measures, the progressive recovery of demand from China, and geopolitical uncertainty.

As for the risks of this scenario, they would focus on a further contraction of domestic economic activity derived from the accumulated interest rate hikes, greater weakness than expected from our main trading partners (especially Germany) and a worsening of geopolitical tensions that would lead to higher prices of energy and food, and even cause some disruption in their availability. This would question possible rate cuts by the ECB and prevent a return to a phase of economic expansion by 2025.

03 Main challenges ahead

The Spanish economy is expected to recover activity in the latter part of the year 2024. However, the new phase of growth will be accompanied by significant challenges. Below we take a look at these challenges:

Fiscal consolidation: The outbreak of the Covid 19 pandemic and the war between Russia and Ukraine led the European authorities to approve a temporary interruption of budgetary control rules in Eurozone countries. According to European Commission estimates, the Spanish general government deficit will close 2023 at 4.1% of GDP and will remain above 3% for the following two years. The announced return to the fiscal rules defined in the Stability and Growth Pact means that the new government's budget for 2024 will have to include adjustments to achieve the 3% target in the medium term.

Development and implementation of NGEU funds: Spain is one of the countries with the largest allocation of NGEU funds: EUR173.67bn considering the addition from the Recovery and Resilience Facility (RRF) funds and the Recovery Assistance for Cohesion and Territories of Europe (the REACTEU funds, set up to deal with the aftermath of the pandemic). More than half of these funds (EUR89.67bn) are non-repayable transfers. If we add the allocation from the REPowerEU Plan,[8] which is part of the Addendum approved in June 2023, the total volume of funds available for investment reaches EUR176.26bn (EUR92.26bn non-repayable and the rest via loans). A huge volume (around 12% of GDP). By the end of the third quarter, Spain had received funds totaling EUR37bn, of which 80% had been allocated.[9]

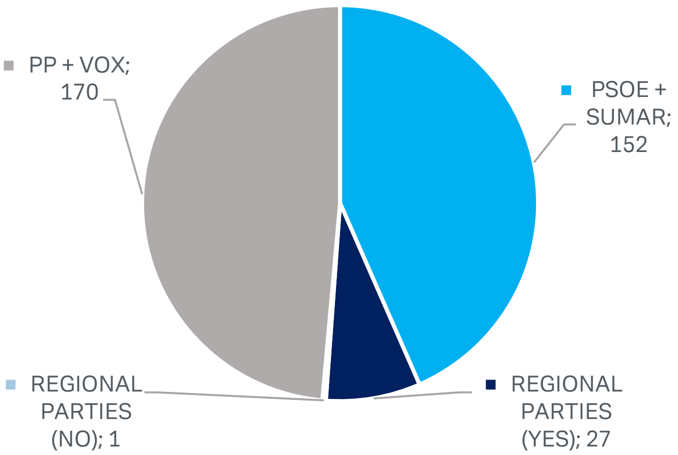
The information available, however, on the implementation of the different projects or their destination by sector or type of company is still scarce. According to Funcas,[10] with data at the end of 2022, the implementation process is still slow, partly due to the numerous administrative stages. Its analysis also concludes that a large part of these funds (64% of those allocated by the State, and 49% by the Autonomous Regions and local authorities) go to large companies, which, given the high weight of small and medium-sized enterprises in the Spanish economy (99.9% of Spanish companies have fewer than 250 workers) generates the perception that the majority of these funds may not reach the real economy.

In 2024, the second phase of the Plan[9] will begin with the entry onto the scene of loans, mostly via the so-called PERTE (Strategic Projects for Economic Recovery and Transformation). The key objective of these is not only to boost growth in the short term, but more importantly, to raise the growth potential of the Spanish economy in the long term. These projects are aimed at specific sectors (such as renewable energies, smart mobility, health, agri-food, circular economy, water, aerospace, etc.) in order to improve the medium-term growth of the economy through investment and innovation. The aim is to put an end to the age-old problem of low productivity in the Spanish economy (according to the OECD,[6] at the end of 2022, labour productivity (GDP per worker) stood at 86.3 points, compared to the OECD average of 89.1 points and the 144.5 points of the top 5 in the group).

Demographic challenge: Spain has one of the oldest populations in Europe. Life expectancy exceeds 80 years for men and 85 for women. At the same time, it has one of the world's lowest fertility rates (1.2 children per woman). According to the National Statistical Office (INE)[11] forecasts, only under very optimistic assumptions (recovery of the fertility rate and a massive influx of immigrants) will the working-age population be maintained. And even with these optimistic projections, in 25 years, the ratio between population over 70s relative to the working-age population (16-70 years) will double (reaching 43%). This is a huge problem which, together with the late entry of young people into the labour market, is fuelling a wide-ranging debate about the future.

The recent reform of the public pension system, with the increase in minimum and non-contributory pensions and the maintenance of the link between pensions and inflation, may pose a challenge for the system. Although measures to encourage later retirement or revenue-raising measures (such as an increase in labour taxes) are also being introduced, population trends make it difficult to ensure that pension expenditure does not continue to grow, so further measures are likely to be needed.

Figure 4: Support for Pedro Sanchez's government



Source: RTVE., Deutsche Bank AG. Data as of November 16, 2023.

04 New government and regional funding

After more than three months following the elections of 23 July, Pedro Sanchez was sworn in as president of the Spanish government on 16 November, thanks to the support of his coalition partner SUMAR, and the support of a large part of the regional parties (a total of 179 positive votes, with a necessary majority of 176 votes, see figure 4). The investiture has also entailed a series of concessions to these regional parties, linked fundamentally, politically, to the situation in Catalonia, and economically, to regional financing. All of this has reopened the debate on the current system of regional and local financing.

In order to understand the Spanish regional financing system, it should be considered that it exists two different models: the common regime and the *Foral* regime (applicable to the Basque Country and Navarre). The difference lies in the management and collection of state taxes. In the 14 Regions (*Comunidades Autónomas*) of the common regime, management and collection is carried out by the State, which subsequently transfers part of these taxes (specially VAT and personal income tax) to the Regions. Meanwhile, the Regions with a *Foral* regime are allowed to manage and collect practically all of these taxes. In exchange, these regions return to the State a fixed amount (the so-called "cupo"), which can be revised every five years. Moreover, within the common regime, the Canary Islands have a special economic and fiscal regime for historical and geographical reasons, regulated on the basis of the European provisions on outermost regions. Ceuta and Melilla, cities located in North Africa, also have a special indirect taxation regime, which means that the Production, Services and Import Tax is applied in their territory instead of VAT.

Regional governments also obtain resources through their own taxes (such as waste taxes, urban housing taxes, vehicle registration taxes, tourist taxes, etc.), direct transfers from the State, or funds from the European Union. They can also obtain financing by issuing debt. However, the debt crisis suffered by the Eurozone altered and modified this financing capacity of the Regions in the international markets. The problems of access to capital markets in a very complicated economic and financial environment led the Spanish government in 2012 to adopt various measures to support the regions. The aim was to reduce the high volumes of debt accumulated by the different regional governments and to facilitate their financing. These measures were encompassed in: i) the Supplier Payment Plan, which enabled local and regional governments to pay their bills in due time and form, thanks to state funding, ii) the Autonomous Community Liquidity Fund (FLA), responsible for financing the debt of the different regions, and iii) the release of certain emergency funds to Autonomous Communities and Local Entities. As of 2015, these three instruments were included in the Autonomous Regions' Financing Fund, which is currently in force. Thanks to this fund, regions have managed to meet their liquidity needs at very low costs, given that the funds are obtained directly from Spanish Treasury debt issues. As a result, at the end of 2022 the Spanish State held almost 60% of the regions' debt.

President Sanchez's investiture agreement with the regional parties involves the revision of the current financing system, with the potential transfer of part of the regions' debt (mainly Catalonia, the most indebted region) to the State. The international rating agencies' initial assessments of this measure suggest that it would temporarily improve the regions' debt volume, but it would probably discourage fiscal control by the regional authorities and would not guarantee a return to the capital markets for the different regions. Hence the importance of a complete overhaul of the regional financing system to guarantee the viability of their accounts in the medium term. The problem is that this issue will probably have to be addressed in an environment of greater fiscal adjustment, which complicates its resolution. For Spanish debt assets, the impact should be minimal, given that the volume of debt is the same (it only changes hands). This explains why the Spanish risk premium (spread 10Y Spanish Bono vs. 10Y Bund) has remained virtually unchanged in recent weeks, following the formation of the new coalition government.

Figure 5: Spreads of 10Y government bond yields in the Eurozone periphery

Source: Deutsche Bank AG, Refinitiv Datastream. Data as of November 30, 2023.

The evolution of debt levels has also been favourable, reaching 111% of GDP in mid-2023, 14ppt below the peak of 125% in March 2021. However, this reduction has been exclusively due to nominal GDP growth, as interest payments and the primary deficit would have increased the debt-to-GDP ratio by more than 11ppt from the 2021 peak. Looking ahead, debt levels are expected to decline gradually, although according to European Commission estimates, they will still be above 105% at the end of 2025.

05 Investment implications

The positive tone of the stock markets since the end of October has also been felt in the Spanish Ibex index, currently at its highest level of the year.

However, the achievement of the 10,000-point barrier will, of course, depend on the performance of the banking sector (which accounts for 30% of the selective index). It is precisely this sector that has been one of the main protagonists of the latest rises. The strength of the fundamentals weighs, which has been demonstrated in the results of 3Q 2023:[12] low NPLs, excess capital and attractive profitability. European banking sector sentiment is suffering from a weakening economic activity, but where there is no perceived risk of recession, it seems that the potential interest rate cuts to be carried out by the ECB in 2024 is weighting positively on investors' sentiment. Let's not forget that, although we expect rates to be cut by 75bps in 2024, starting in the summer, rates are also expected to remain high for quite some time, favouring traditional banking business.

The rate cuts would also be a favourable factor for the electricity sector throughout 2024, while in 2023 elevated interest rats it have been a drag. Regulatory uncertainty continues to weigh on the sector, although it seems that much of it is already reflected in its prices.

Finally, large Spanish multinationals in the construction, concessions and civil works sector remain attractive in view of the large construction, renovation or improvement projects of a multitude of infrastructures on both sides of the Atlantic.

In fixed income, the spread between Spanish Bono-Bund is expected to remain at around 110-100bps at the end of 2024. Despite political uncertainty (coalition government, no absolute majority), confidence in the ECB's new Transmission Protection Instrument (TPI), designed to guarantee financial markets' stability, the necessary fiscal restraint and a debt service that, according to estimates by the Bank of Spain,[13] would reach 2.5% of GDP (compared with the current 1.9%, still very low compared with the peak of 4.1% reached in 2011, in the midst of the debt crisis), would serve as support.

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The European Central Bank (ECB) is the central bank of the euro area.

EUR is the currency of the euro area.

The Eurozone consists of 20 countries of the European Union that have adopted the euro as their common currency.

Gross Domestic Product (GDP) is the monetary value of all finished goods and services produced within the borders of a country in a given period of time.

The IBEX 35 is the stock market index by capitalisation that includes the 35 largest companies on the Madrid stock exchange.

The International Monetary Fund (IMF) was founded in 1944, includes 189 countries and seeks to promote international cooperation, exchange rate stability and economic development. FUNCAS is a Spanish centre of analysis dedicated to economic and social research, promoting interaction between the academic sphere and the real economy.

The Instituto Nacional de Estadística (INE) is Spain's official statistics agency.

The Next Generation EU Fund (NGEU) is a recovery package developed by the EU to support member states to combat the consequences of Covid 19.

PERTES (Proyectos Estratégicos para la Recuperación y Transformación Económica) are a new public-private partnership instrument aimed at promoting major initiatives that contribute to the transformation of the Spanish economy.

The People's Party (PP) is a conservative and Christian-democratic political party in Spain.

The Spanish Socialist Workers' Party (PSOE) is a social-democratic political party in Spain.

SUMAR is a left-wing political party in Spain. Podemos is also now integrated into SUMAR.

The Recovery, Transformation and Resilience Plan is the key instrument of the EU's Next Generation Fund. It sets the path for the modernisation of the Spanish economy, economic recovery and job creation after the effects of the Covid pandemic and prepares the economy for the challenges of the future.

Transmission protection instrument (TPI) is an instrument that is intended to support the effective transmission of monetary policy and ensure that the monetary policy stance is communicated smoothly across all euro area countries.

VOX is a right-wing political party in Spain.

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