Spain and its territorial entities in 2Q 2024: Spanish economy will surprise again in 2024, but in the medium-term macro and fiscal challenges remain

Macro perspectives for Spain and the finances
of its Regional Governments

2Q2024 **EXECUTIVE SUMMARY**

BFF INSIGHTS

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Executive Summary

International environment

Despite still being immersed in a turbulent environment, global economic activity remains somewhat resilient. The ECB estimates that global economic activity, excluding the euro area, increased by 3.5% in 2023, a rate similar to the average growth of the last decade. And this in a context in which the tightening of monetary policy was passed on to global consumer demand, with two active armed conflicts (Ukraine and the Middle East) and growing trade fragmentation. This result largely reflects the performance of the United States, whose economic activity continued to be robust, where private consumption was the most dynamic component of demand, supported by the good performance of employment, real income gains in the face of lower inflation, the fiscal stimulus and the use of savings accumulated during the pandemic, while the euro area maintained notable weakness throughout 2023 and economic growth in China slowed.

The international environment has been characterized in the recent period by three major trends. First, global economic activity has remained more dynamic than expected in 2023, despite the hawkish tone of monetary policy and geopolitical uncertainty. This resilience has been based, in part, on the strength of employment in most economies and, in some regions, on fiscal policy support. However, **the heterogeneity by geographical area was significant,** contrasting, for example, **the upward surprise in GDP growth in the United States and China with the weakness of the euro area.**

Second, **the continuation of the disinflationary process is noteworthy,** even with a greater intensity than expected, influenced by the fall in energy commodity prices, the fading of the adverse supply shocks of previous years and the impact of the cumulative tightening of monetary policy. Inflation rates are also expected to continue falling in the coming quarters, an expectation that also depends fundamentally on the absence of an escalation in armed conflicts and geopolitical tensions.

Third, **international financial markets have seen significant movements in recent months, with stock market gains and long-term interest rate reductions,** while discounting that the central banks of the major advanced economies – including the ECB – will soon reduce their interest rates, although the magnitude of the expected rate cuts in 2024 has been significantly reduced due to a certain stagnation in the disinflation process in recent months, mainly in the US economy, while fears of a possible excessive overheating of the latter have increased. By the end of April, the market would be pricing in only two 25 bps cuts by the Fed in 2024 and between two and three by the ECB.

As for the euro area, **economic activity has continued to show clear weakness and is only expected to increase its degree of dynamism gradually.** The weaker economic activity and the moderation of inflation in the euro area in recent quarters – which has been more pronounced than expected – could point to a somewhat stronger than expected transmission of monetary policy, but also to longer-lasting effects, for example through a deterioration in international competitiveness, or the energy crisis, to which the Economic and Monetary Union (EMU) has been more exposed than other world regions.

On the other hand, **inflation has performed better than expected,** mainly due to the sharper-than-anticipated correction in energy prices. The slowdown in inflation is more intense in the euro area than in the United States, in a context of weaker demand. Thus, the ECB has revised downwards the inflation forecast for 2024 to 2.3%, and the Harmonised Index of Consumer Prices is expected to stand at 2.0% in 2025 and 1.9% in 2026. However, much of this slowdown is due to lower gas prices on global markets and slower progress in the case of food. On the other hand, wage growth remains somewhat high in the euro area as a whole, which could put the inflation slowdown at risk.

In addition, the risks around these inflation projections are, in our view, balanced. Upside risks include escalating geopolitical tensions, which could drive a sharper rise in energy and freight prices. Inflation could also rise more than expected if wages rise more than expected or if profit margins show greater resilience. Conversely, however, inflation could be lower if the above-mentioned downside risks to growth materialize.

Risks from the global environment remain skewed to the downside. On the one hand, active armed conflicts in Europe and the Middle East may worsen and spread to other geographical areas, keeping uncertainty at high levels and leading to new disruptions in trade such as those in the Red Sea, where attacks by the Houthi rebels on cargo ships beginning their transit– on the way to the Suez Canal – have led to the largest companies divert much of this traffic to the Cape of Good Hope, significantly increasing sailing time and shipping costs. Added to this is the increasingly evident fragmentation of trade relations, which, together with moderate productivity growth in most advanced economies, could lead to further downward revisions to medium- and long-term growth prospects.

The Spanish economy will perform better than expected in 2024

The Spanish economy showed high growth throughout 2023, which exceeded the forecasts of most analysts and what was observed in the euro area. Real GDP growth in 2023 was 2.5%, according to the most recent estimates from the National Institute of Statistics (INE). This growth was lower than that observed the previous year (5.5%), but exceeded the consensus forecasts of analysts and the Government. The resilience of private consumption, driven by population and employment growth, and the growth of public consumption and exports of services help to explain this dynamism. On the other hand, investment in equipment and construction maintains a weak tone.

For 2023 as a whole, the resilience of the economy would have contributed, on the supply side, to **Spain's favourable sectoral structure, with a greater weight of sectors that show a positive performance,** such as those related to tourism, where revenues have far exceeded pre-pandemic levels, to which geopolitical instability in competing destination markets may have contributed, and the reduced impact of rising energy prices on industry; while, on the demand side, the dynamism of consumption has been the main factor supporting activity, including public consumption. Likewise, the Spanish economy has also benefited from population growth, which is entirely explained by the positive flows of immigration that have favoured an expansion of consumption above what was previously considered. In fact, job creation has remained very dynamic, helped precisely by the impetus from foreign workers. In this regard, in 2023 as a whole, the group of foreign national workers provided a strong boost to affiliation, with an average growth of 9.5%, compared to the 1.7% presented by the Spanish affiliates.

The new edition of the report updates the projection of the 1Q and **estimates that GDP growth will surprise on the upside by 0.4 points to 2.0% in 2024,** supported by the dynamism of private consumption, the positive surprise in growth observed in 2023, the carry-over effect associated with a greater quarterly advance than initially expected in the final months of the year (of 0.6%) and by an expansion in conditional investment the deployment of the investments associated with the RTRP. Private consumption will be supported by employment growth, the savings accumulated by Spanish households, and the gradual disappearance of the restrictive impact associated with the tightening of financing conditions in 2023 (Figure 1).

FIGURE 1 **Baseline scenario for the growth of the Spanish economy in 2024-2028**

	Base case scenario April 2024					
Annual variation rate	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**
Private national final consumption expenditure	1.8	2.4	2.0	1.9	1.7	1.6
Final consumption expenditure of the Public Administrations	3.8	1.2	1.3	1.0	1.0	1.1
Gross fixed capital formation	0.8	2.7	2.1	1.9	1.4	1.3
GFCF capital goods and cultivated assets	-1.3	3.9	2.7	2.3	1.4	1.3
GFCF Constrution and Intellectual property	1.7	2.2	1.8	1.7	1.4	1.3
National Demand*	1.7	2.1	1.8	1.6	1.4	1.4
Export of goods and services	2.3	2.1	3.1	3.1	3.0	2.8
Import of goods and services	0.3	2.6	3.2	3.2	2.9	2.9
Foreign balance*	0.8	-0.1	0.1	0.1	0.1	0.1
Gross domestic product	2.5	2	1.9	1.7	1.6	1.5
Nominal gross domestic product	8.6	5.2	4.1	3.7	3.6	3.4
Gross domestic product deflator	5.9	3.2	2.2	2.0	2.0	2.0
CPI	3.5	3.1	2.2	2.0	2.0	2.0
Equivalent full time employment	3.2	2.5	1.5	1.5	1.5	1.4
Unit labor cost	6.0	3.8	1.5	1.6	1.8	1.8
Productivity per full time employee	-0.7	-0.5	0.4	0.3	0.1	0.0
Compensation per employee	5.2	3.3	2.0	1.8	1.8	1.8
Unemployment rate (active population %)	12.1	11.6	11.1	10.8	10.8	10.7
Household saving rate and NPISH (gross disposable income %)	11.7	9.7	8.8	8.3	8.0	7.6

*Source: INE and Authors' own elaboration**
**contribution to GDP growth*

By 2025, there are concerns that the slowdown in growth in certain sectors and countries in the euro area will be more structural than initially thought. The German economy has shown virtually no progress for two years. The improvement in the French economy is meagre if we take into account the high imbalance in its public accounts. The industrial export growth model seems exhausted. In both Spain and Germany, the companies that have performed the worst are those that are energy-intensive or part of the same value chain. Moreover, in an environment of fiscal consolidation and still high interest rates, it will be difficult for domestic demand in countries with deficits above 3% of GDP to contribute to growth.

The new fiscal rules in Europe will require significant and sustained adjustments over time in several economies, including Spain, from 2025 onwards. Countries such as France, Spain or Italy, with deficits above 3% of GDP and public debt levels above 90%, will have to commit to implementing structural consolidation measures between 0.4 and 0.6 pp of GDP per year. Moreover, the gap between the current data and the targets is so great that efforts will have to be extended for at least five years, or even longer. At best, the combination of a strong recovery, underpinned by RTRP-linked funds and an ambitious reform agenda, could limit the impact of consolidation.

The main source of risk in the current projections exercise remains, as in previous years, geopolitical uncertainty on a global scale and, in particular, the possibility of an escalation of the armed conflicts that are active in Ukraine and the Gaza Strip. The impact on activity and prices of the cumulative tightening of monetary policy is another relevant source of uncertainty.

Other significant sources of uncertainty about the central scenario of these projections come from the national level and have to do with possible second-round effects on inflation and the deployment of NGEU funds.

Finally, the reactivation of fiscal rules at the European level – suspended since the beginning of the pandemic – introduces a significant risk to the central scenario of the current projections. Compliance with these rules will require the design and implementation of a medium-term fiscal consolidation plan that allows for a sharper correction of the structural public deficit than that contemplated in these projections. Although the economic impact of this adjustment plan is uncertain – and will depend critically on how it is designed – its implementation would foreseeably lead to a lower degree of dynamism in activity over the projection horizon than that contemplated in this forecast exercise.

Regarding the extraordinary financing mechanisms and with the latest data available until the second quarter of 2024 - which includes the allocation of the extra-FLA to meet the pending financing of the 2023 deficit deviation (EUR6,719mn) and up to the end of 2Q24 -, **a total of 16,396.63 million euros have been allocated YTD through the Financing Fund for Autonomous Communities** in its two compartments, Financial Facility (Andalusia) and Liquidity Fund (Aragon, Castile-La Mancha, Catalonia, Extremadura, Murcia and Valencia). Catalonia (EUR5,530mn) and Valencia (EUR5,328mn) are the autonomous communities that have received the most funds in this way.

Based on the financing programs of the Autonomous Communities for 2024, we estimate that the final volume of funds that the regions assigned to the extraordinary financing mechanisms will receive in 2024 will be around EUR 31,000 mn, including the amount assigned to the extra -FLA of 2023, with the former figure representing around **70% of the total financing needs for 2024 of the Spanish regions.**

Vulnerability analysis of the Spanish economy

In any case, **it is worth highlighting some specific risks to the Spanish economy.** In the first place, unit labour costs have been showing high growth in our country despite the fact that there is a moderate upturn in negotiated wages. This growth in remuneration, in an environment of increasing non-wage labour costs (e.g. social contributions) and weak productivity performance, **has led to increases in unit labour costs above those observed in the rest of the EMU countries** since the beginning of the pandemic, which could end up affecting the price competitiveness of Spanish companies.

Secondly, according to the results of the Bank of Spain's latest Survey on Business Activity, **companies have perceived an increase in uncertainty about economic policy in recent quarters,** which is negatively affecting 58% of companies, so that it has become the main conditioning factor for activity reported by the latter.

The weakness of investment is one of the most notable features of the recent growth pattern of the Spanish economy, particularly in a context in which some projects linked to the Recovery, Transformation and Resilience Plan are materializing.

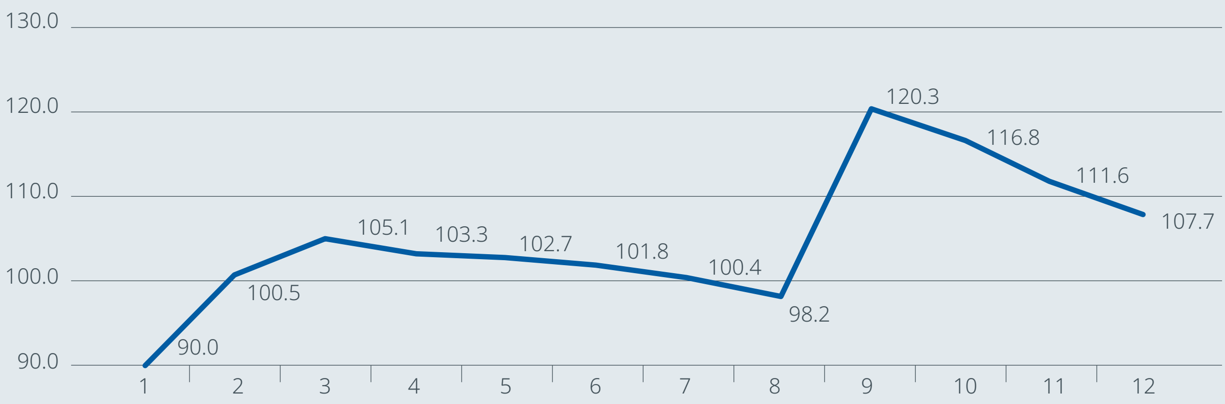
Thirdly, **the projections are particularly conditioned by the pace of implementation of the NGEU programme, for which it is assumed, as I said, that its momentum will gain traction in 2024 and 2025.**

Fourthly, **there is still a high structural government deficit and public debt, which represent a source of vulnerability that should not be underestimated,** especially in a context of higher financing costs. In this regard, strict compliance with the new fiscal rules should ensure the sustainability of public accounts and allow fiscal policy to generate room for manoeuvre in the face of future negative shocks. This compliance will require the design and implementation of a fiscal consolidation plan that allows for a sharper correction of the structural public deficit than that envisaged in the Bank of Spain's projections.

Fiscal and debt sustainability scenario

2024 is going to be a year full of challenges for public finances. Spanish debt remains above 100% of GDP (Figure 2) and, in the medium term, will increase due to the pressure of expenditure associated with ageing and other factors such as pressure on health and defence spending. Added to this vulnerability is the challenge of complying with the new European fiscal framework and translating it into the Spanish reality. Spain will have to send to the European institutions next September a medium-term fiscal strategy that will reduce the debt in a sustained manner. Also in September, the Spanish Public Administrations will have to prepare their budgets for 2025.

FIGURE 2 Annual evolution of Spain's public debt (% GDP, 2012-2023)



Source: INE and Bank of Spain

For its central scenario, AIReF estimates a fiscal deficit of 3% of GDP in 2024, in line with the government's forecasts, which represents a reduction of six tenths of a percentage point compared to the 2023 figure of 3.6%, almost three tenths of GDP below the forecasts published in the Budget Plan (Figure 3).

FIGURE 3 **Evolution of the general government budget balance (2024-2028, % GDP)**

	Current AIReF					October 2023 AIReF				
	2024	2025	2026	2027	2028	2024	2025	2026	2027	2028
AA.PP	-3.0	-2.9	-3.1	-3.2	-3.2	-3.0	-3.2	-3.2	-3.2	-3.2
A.C	-2.7	-2.2	-2.4	-2.5	-2.6	-3.1	-2.8	-2.8	-2.9	-2.9
F.S.S.	-0.3	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
CC.AA	-0.1	-0.3	-0.3	-0.2	-0.2	0.2	0.0	-0.1	-0.1	-0.1
CC.LL	0.1	0.0	0.0	0.0	0.0	0.2	0.1	0.1	0.1	0.1

Source: AIReF

In the medium term, AIReF considers that the deficit will stabilise, in the absence of additional measures, at around 3.2% of GDP, in line with an estimate of public revenues that increases gradually to 43% of GDP in 2028 (42.5% in 2024 excluding RTRP revenues) and a level of public expenditure that in the medium term would stand at 46.2% of GDP (45.4% 3n 2024 excluding the RTRP).The Recovery, Transformation and Resilience Plan (RTRP) and the REACT-EU funds have a neutral effect on the deficit, although they affect the level of revenue and expenditure.

The deficit will continue to shrink in 2025 due to the disappearance of the last measures to combat the energy and price crisis. Thereafter, there will be a worsening of the deficit in 2026 due to the disappearance of the temporary revenue measures and then it would stabilise at around 3.2%. On the other hand, the path set out in the Update of the Stability Programme places the deficit at 2.5% of GDP.

Focusing on the territorial administrations, **the deficit of the Autonomous Communities will be reduced in 2024 to 0.1% of GDP.** The improvement in the deficit of the regions is mainly due to the extraordinary income from the liquidation of the regional financing system. In addition, State account transfers will also grow by 8.3%. On the negative side, we would highlight the worse-than-expected closing of 2023 and the new information on the resources of the financing system planned for 2024. After the extraordinary settlement received in 2024, from 2025 onwards the fiscal balance of the regions will deteriorate to around 0.2% of GDP deficit.

Spain's debt-to-GDP ratio stood at 107.7% at the end of 2023, a reduction of 4 points in the year and an increase of 9.4 points compared to the pre-pandemic level. Nominal GDP grew by 8.6% in 2023. The contribution of growth to the fall in the ratio was 8.8 points, of which 2.6 points came from real growth, and 6.2 points from the GDP deflator. On the other hand, the primary balance, the interest burden and the stock-flow adjustment have contributed positively to the increase in the ratio, totalling 4.9 points of GDP. This contribution represents a reduction of six tenths compared to last year (Figure 4).

FIGURE 4 Change in public debt in 2023 (% GDP) by component

Source: AIReF

The reduction in the public deficit, together with the growth in activity and much higher than expected inflation, have managed to correct approximately two-thirds of the increase in the debt ratio generated in the first year of the pandemic, placing it on a downward path. **The update of the macro-fiscal forecasts prepared by AIReF projects a decrease in the debt-to-GDP ratio of 1.8 points this year, placing it at 105.8%,** a reduction that will be mainly supported by nominal GDP growth, where the deflator will make a very significant contribution. This forecast is slightly better than that presented by the Government in the draft Budget Plan for 2024 (106.3%), and it is in the range of the latest forecasts by the IMF (104.7%) and the European Commission (106.5%).

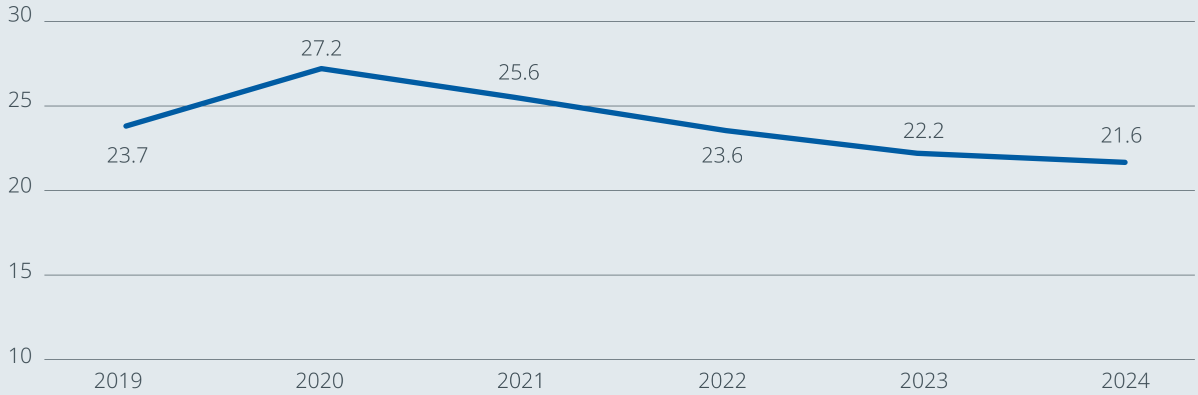
However, Spain is currently one of the EMU countries with the highest levels of debt, behind Greece and Italy and with a level similar to that of Portugal and France. In 2019, Spain was already one of the countries in the euro area with the highest debt ratio, and the pandemic has helped to consolidate this situation. Despite the 18-point reduction from the ceiling, Spain, along with France, are the countries that have increased their debt the most due to the COVID crisis, and those that maintain some of the highest deficit levels. By contrast, Portugal, after a similar initial upturn, has managed to reduce its deficit over the past three years to almost a balanced budget.

Beyond 2024, when the significant contribution of nominal growth disappears, the pace of debt reduction is projected to slow down, with the debt ratio stabilising at around 105% of GDP. The moderation in the contribution of nominal growth, which will slide slightly downward in the period 2025-2028 (from 4.1% to 3.4%), with an upward trend in interest rates (from 2.6% to 3%) and a stabilised primary balance (-0.3%), will result in a slowdown in the pace of reduction in the debt ratio, which will run out in 2028.

In the medium and long term, AIReF projects an unfavourable evolution of the debt-to-GDP ratio. In its long-term inertial scenario, AIReF projects an increasing debt ratio after an initial period of some stabilisation. The foreseeable increase in expenditure associated with the ageing of the population is one of the main challenges to the sustainability of public finances in the medium and long term. The high initial indebtedness, added to unbalanced public accounts, will generate an unfavourable dynamic in the financial burden, even in a scenario of containment of the cost of debt. In its long-term scenario, AIReF projects that the interest expense to GDP ratio will gradually and steadily increase from 2.5% of GDP in 2023 to around 4.5% over the next 15 years.

AIReF forecasts that the debt of the Autonomous Communities will reach 21.6% of GDP in 2024, down by more than half a point from the previous year (Figure 5). Starting from 22.3% in 2023, the ratio would improve due to the effect of the expected GDP growth, partially offset by the financing of the deficit in 2023 and the expected fiscal execution in 2024.

FIGURE 5 **Expected evolution of the indebtedness of the Autonomous Communities (% GDP)**



Source: Bank of Spain and AIReF

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+39 02 7705 8342 | insights@bff.com

Author: Cristina Nogaledo Castaño
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