1

RISKS LINKED TO THE MACRO-FINANCIAL ENVIRONMENT

Despite the economic growth observed in 2022 H1, soaring consumer and input prices have contributed to a slight deterioration in the financial and economic position of firms and households, particularly in some of the more vulnerable segments. In addition, higher interest rates have had an adverse effect on indebted agents' disposable income. The impact on debt servicing has so far been very moderate. However, it will become more important in the coming months as the pass-through of higher market rates to the cost of debt is completed and the monetary policy normalisation process continues. In the short and medium term, a considerable economic slowdown, whose scale is highly uncertain, is expected in Spain and globally, and adverse macroeconomic scenarios involving a downturn in activity cannot be ruled out if certain risks, linked mainly to the economic fallout from the war in Ukraine, materialise. Under these scenarios, households' and firms' debt servicing capacity would be further impaired, which could adversely impact financial institutions' balance sheets. The adverse impact that this would have on financial stability could be amplified by the possibility of further drops in financial asset prices and of these declines spreading to real estate assets, particularly in the event of a disorderly correction. According to the latest available data, real estate market activity and prices continue to grow at high paces, although there are some signs of deceleration, which will not be confirmed until new information becomes available. Indeed, higher uncertainty, the reduction in households' real income and tighter financial conditions can all be expected to curb the growth of the real estate market in the coming quarters.

1.1 Macroeconomic environment

1.1.1 Systemic and materially significant countries

2022 has so far been marked by the outbreak of the war in Ukraine, which has driven up energy and food commodity prices significantly and exacerbated global inflationary pressures. The prolongation of the war, with Russian gas and oil exports gradually being interrupted, and the persistence of high inflation rates have adversely affected global economic activity, which has slowed more than expected.

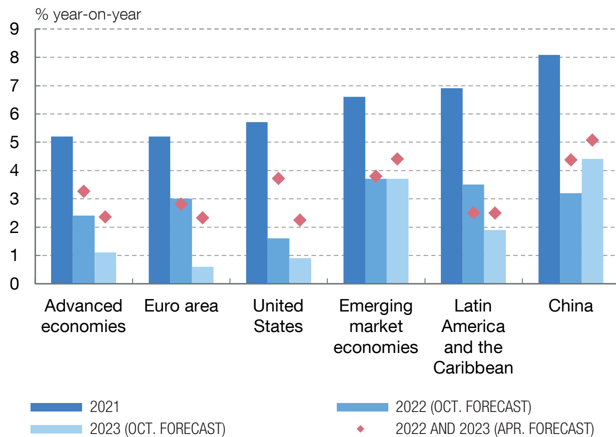
The growth outlook for 2022 and 2023 has deteriorated in practically all areas, mainly in the advanced economies (see Chart 1.1.1). Despite the bottlenecks that have affected global value chains since 2021 easing slightly, higher inflation – which has triggered a fall in real disposable income and a tightening of financial conditions – has increased the probability of a recession in the main developed economies (see Chart 1.1.2). Indeed, the United States recorded negative gross domestic product (GDP) growth

Chart 1.1

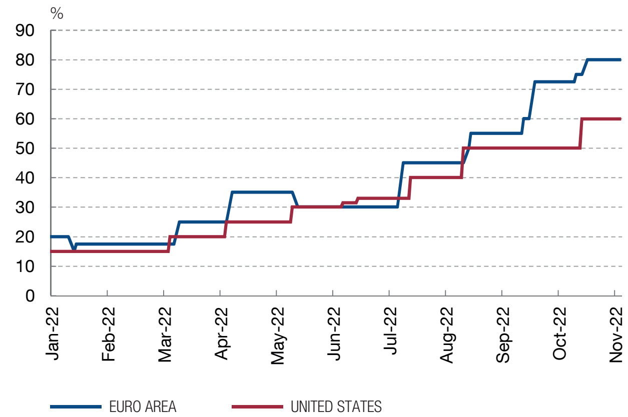
GLOBAL ECONOMIC ACTIVITY IS SLOWING AMID HIGHER INFLATION AND MONETARY POLICY TIGHTENING

Growth forecasts have been revised down since the last FSR and the probabilities of a recession in the advanced economies have increased. Inflation rates have surprised on the upside and have led to more restrictive monetary policies in the main economies.

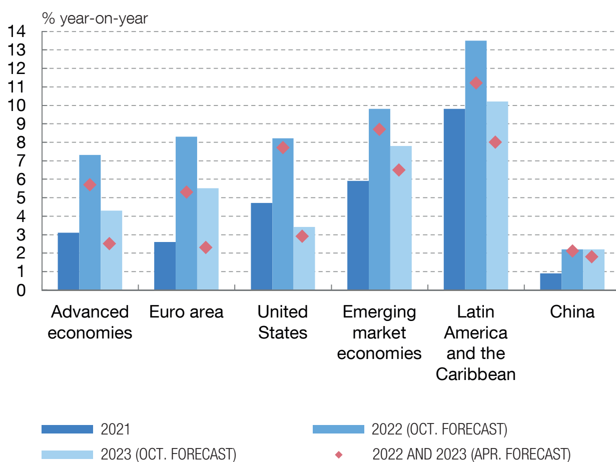
1 GDP GROWTH FORECASTS (2021-2023)
IMF WEO October 2022



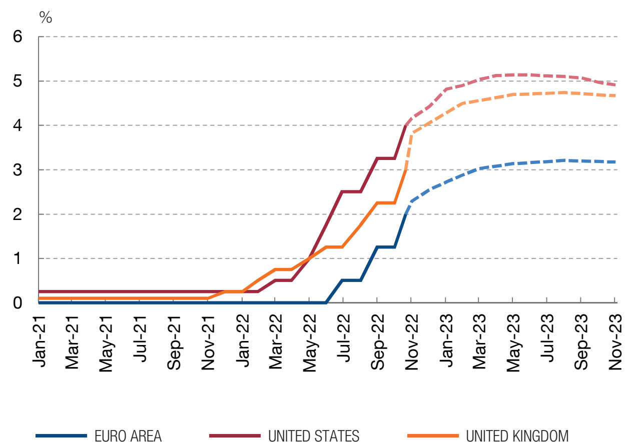
2 PROBABILITY OF A RECESSION ONE YEAR AHEAD. EURO AREA AND THE UNITED STATES (a)



3 INFLATION (2021-2023)
IMF WEO October 2022



4 MONETARY POLICY: POLICY INTEREST RATES (b)



SOURCES: IMF, Bloomberg, national statistics and Refinitiv.

a These indicators are based on responses to surveys conducted by Bloomberg on the probability of a recession one year ahead. The indices used are: US Recession Probability Forecast Index and Eurozone Recession Probability Forecast Index.
b The broken lines denote futures-based expectations. The following indices are used: 3-Month SONIA Index, 30-Day Federal Funds Composite (Chicago Board of Trade) and 3-Month EURIBOR.

in 2022 Q1 and Q2, although in Q3 GDP growth returned to positive territory. Euro area activity slowed in 2022 Q3, with these dynamics expected to intensify in 2022 Q4 and 2023 Q1, following an upturn in 2022 H1 boosted by all restrictions on the economic sectors hardest hit by the pandemic being lifted. Different international organisations and analysts have significantly revised down their latest euro area GDP growth forecasts, pointing to euro area GDP stagnating in 2023, after growing at around 3% in 2022.

The risks to global growth are clearly tilted to the downside. In the euro area, the main source of risk is associated with the uncertain consequences of the drastic reduction in the supply of gas from Russia and will also depend on the severity of the winter. Europe is particularly exposed to the effects stemming from the invasion of Ukraine, due to its geographical proximity and, particularly, to its high dependence on fossil fuel imports from Russia. More broadly, heightened geopolitical tensions in different parts of the world could affect, in the medium term, the globalisation of the world economy, thereby exacerbating the bottleneck issues (see Box 1.1). Another source of risks would stem from synchronised interest rate hikes and the knock-on tightening of financial conditions against a backdrop of high government and private debt in many economies. An abrupt deceleration in China because of its zero-COVID strategy and its real estate crisis could also have adverse effects on world trade and the global economy.

Global inflation has remained high since the last Financial Stability Report (FSR) was published in the spring, with successive upward revisions to the forecasts. The persistence of the inflationary pressures is attributable to different factors, including most notably global supply chain disruptions, higher energy prices as a result of the Russian invasion of Ukraine, the strong recovery in demand since 2021 and, in some cases, such as the United States, increased labour costs. Inflation forecasts for 2022 and 2023 have been revised up across the board (see Chart 1.1.3), although inflation is expected to ease from next year. In the euro area, the significant increase in food prices and the depreciation of the euro against the dollar have been additional factors behind the persistence of inflation. The recent fall in energy input prices could ease inflationary pressures if it persists over time. The latest inflation forecasts have been revised up significantly, expecting euro area inflation of over 8% in 2022 and over 5% in 2023.

In response to high and persistent inflation, central banks have tightened their monetary policy stance with some synchronisation. For example, among the main advanced economies, the Federal Reserve Board, the ECB and the Bank of England[1] have quickened the pace of interest rate hikes (see Chart 1.1.4), in order to bring inflation back to values compatible with monetary policy targets and keep expectations anchored. Policy interest rate hikes, which are expected to continue in the coming months, together with the increase in risk premia due to greater uncertainty, have resulted in tighter global financial conditions and a widespread, albeit uneven across countries, increase in financing costs for firms and households, against a general backdrop of high government and private debt levels. Although the measures are heading in the same direction, the differences in the forcefulness of the interest rate hikes and their announcement dates mean the monetary policy

1 However, the Bank of England also had to intervene by buying government bonds to stabilise longer-term interest rates and the exchange rate following the financial market response to the announcements by the previous UK government of a more expansionary fiscal policy.

adjustments are having slightly heterogeneous effects on the different advanced economies. These differences are also being reflected in exchange rates, likewise affected by the heterogeneous effects of higher commodity prices on the different countries and geographical areas.

More restrictive monetary policies globally and the appreciation of the dollar have given rise to a tightening of financial conditions in emerging market economies. Thus, in 2022 to date emerging market economies have recorded stock price drops, higher risk premia and capital outflows (see Chart 1.2.1). The markets in Latin America have performed relatively better overall, helped by the rise in commodity prices and by the early monetary policy response in those countries. Meanwhile, markets have performed more poorly in eastern Europe and, especially, in China, which recorded high portfolio capital outflows. Surging inflation in the emerging market economies could have peaked or be close to peaking, and the analysts' consensus expects it to stand, in most cases, at values just slightly above pre-pandemic levels at end-2023 (see Chart 1.2.2). Against this backdrop, central banks in Latin America and eastern Europe maintained the contractionary monetary policy stance (see Chart 1.2.3). The monetary authorities of Emerging Asia (excluding China, which is facing a considerable adjustment to its oversized real estate sector) followed suit, but Russia and Turkey did not. The widespread tightening of financial conditions could have particularly adverse effects on those emerging market economies with high levels of debt and greater external financing needs. Among the systemically important countries for Spanish banks, Turkey stands out as one of the vulnerable countries.

The following can be noted in regard to the main emerging market countries to which Spanish banks are exposed:

In **Mexico,** despite GDP still not having reached pre-pandemic levels, the Banco de México continued tightening the monetary policy stance in order to contain high inflation, with underlying inflation reaching rates of over 8% in August. Credit to the private sector remained weak, especially lending to firms, against a backdrop of a low NPL ratio and high solvency and liquidity ratios.

Brazil's economy grew more than expected in the first half of the year, driven by private consumption. The inflation rate began to ease from April, thanks in particular to the tax cuts introduced by the government to contain fuel prices. However, underlying inflation has remained above 8%. The Banco Central do Brasil continued to raise the policy interest rate, albeit more slowly than in prior months, to 13.75% in August 2022. In addition to the risks common to the region's other economies, the outlook for Brazil is also influenced by fiscal policy. This is because the country has a very high level of government debt, whose cost is growing as it is largely indexed to policy interest rates and the inflation rate.

In **Turkey,** the economy continued to display strong momentum in the first half of the year, with GDP growing 7.5% year-on-year, while some of its main imbalances

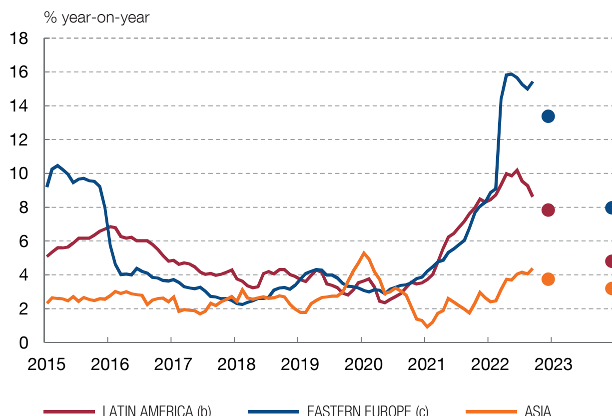
Chart 1.2

MONETARY POLICY REMAINS CONTRACTIONARY IN THE EMERGING MARKET ECONOMIES, AGAINST A BACKDROP OF INFLATION AND FINANCIAL STRESSES THAT ARE EASING SLIGHTLY

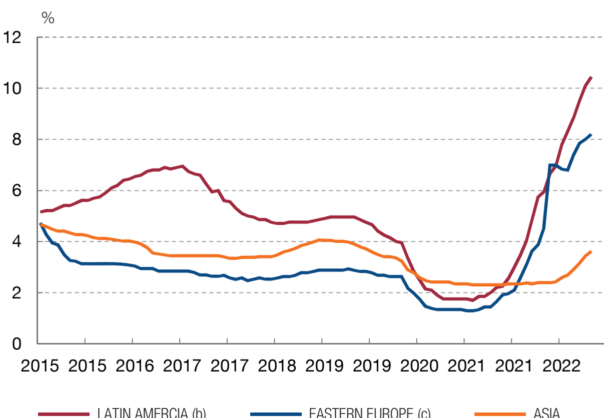
Financial markets in the emerging market economies have been particularly affected by the tightening of global financial conditions in 2022, although there have been some signs of the impact easing in recent months. Inflation rates peaked in June, and at end-2023 they are projected to be close to pre-pandemic levels, except for in eastern Europe. With the notable exception of Turkey, the central banks maintained a very contractionary monetary policy stance. September saw the end of the interest rate hike cycle in Brazil, the country that began the restrictive cycle earlier.

1 FINANCIAL CONDITIONS

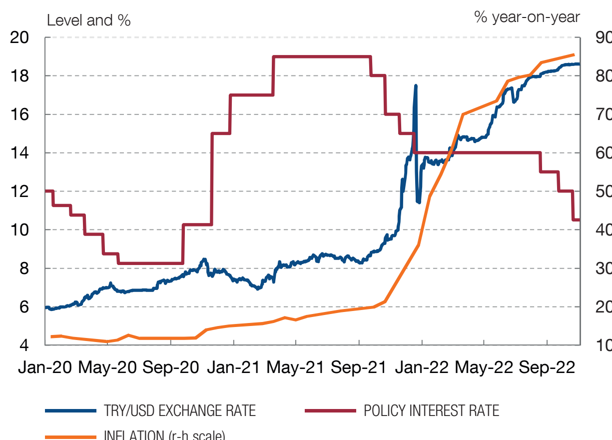
2 INFLATION (a)



3 POLICY INTEREST RATES



4 TURKEY: INFLATION, INTEREST RATE AND EXCHANGE RATE



SOURCES: Refinitiv, Consensus Forecasts and national statistics.

a The dots denote inflation expectations for end-2022 and end-2023, according to the Consensus Forecasts, in October 2022.
b Excluding Argentina.
c Excluding Turkey.

worsened further (see Chart 1.2.4). Inflation continued to surge, reaching 85.5% year-on-year in October; even so, the Central Bank of the Republic of Turkey has cut its reference interest rate by a total of 250 basis points (bp) at its last three monetary policy meetings, to 10.5%. It also introduced measures to control the growth of lending (except lending to firms in sectors of interest) and to limit its cost. Lastly, higher energy import prices and the increase in gold imports, possibly due to it

acting as a safe-haven asset, have enlarged the current account deficit, which amounted to 4.8% of GDP halfway through the year.

1.1.2 Spain

After the upturn in activity in Q2, the Spanish economy has lost steam in Q3, due to the effects of inflation on households' and firms' income. Despite the boost from tourism expenditure in the absence of health restrictions, the Spanish economy decelerated in Q3, weighed down by the same factors affecting global activity. High inflation rates have gradually spread to an increasingly larger set of goods and services, impacting cohorts unevenly. Lower-income households have experienced higher inflation because staple goods, whose prices have shown a greater relative increase in recent times, account for a larger share of these households' spending. Consumption could be further affected, as the current highly uncertain environment may prompt an increase in precautionary saving, which seeks to mitigate possible further declines in income.

In the medium term, economic growth has also been revised down because inflation is proving to be higher and more persistent than expected. On the latest Banco de España projections, GDP will end 2022 around 2.3 percentage points (pp) below its pre-pandemic level (see Chart 1.3.1).[2] In addition, thereafter the recovery will be weaker than previously projected due to the surge in prices and costs. Indeed, the upward revision to inflation in 2023, in both Spain and the euro area, is also becoming attributable to consumption basket items other than the energy component, i.e. food and underlying inflation. Higher energy prices have been passed through to final prices and costs more in recent months. The recent drop in energy prices could help alleviate inflationary pressures later on provided it persists over time.

The tightening of financial conditions and the deterioration in the external environment are also lowering growth expectations. As mentioned above, higher inflation has led both the ECB and other central banks to embark on monetary policy normalisation, by raising policy interest rates. Such interest rate hikes have started to feed through to the cost of financing for Spanish firms and households, albeit at a slower pace than in the past (see Box 1.2). In any event, this will tend to increase their debt burden and reduce their disposable funds for consumption and investment. In addition, the recent considerable deterioration in the external environment is also undermining Spanish export expectations, despite the gain in competitiveness that the euro's depreciation against the dollar represents.

Some factors – such as the Next Generation EU (NGEU) funds, the gradual easing of global supply chain disruptions and continued inbound tourism

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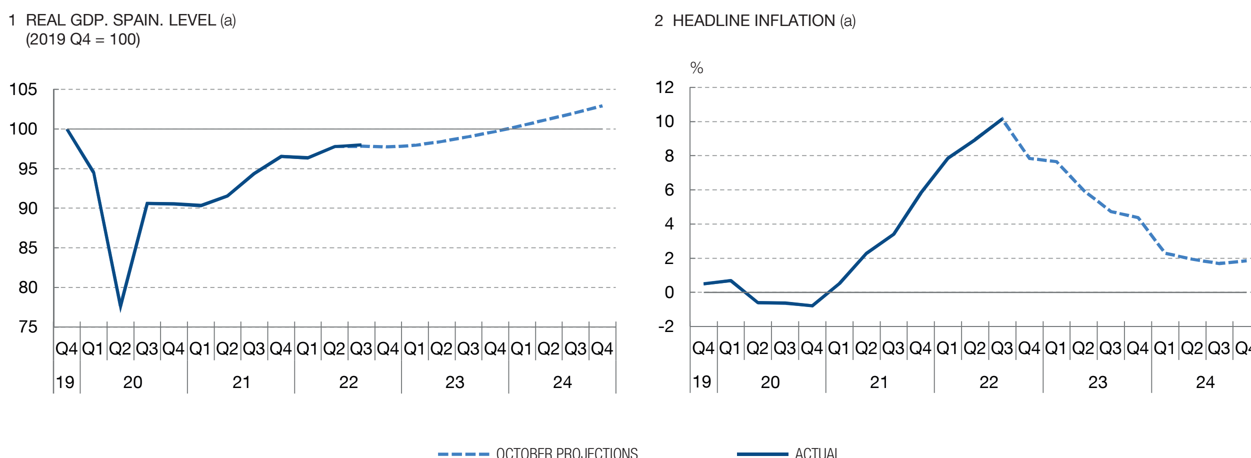
2 See Box 1, "Macroeconomic projections for the Spanish economy (2022-2024)", "Quarterly Report on the Spanish Economy", *Economic Bulletin* 3/2022, Banco de España.

Chart 1.3

THE SPANISH ECONOMY IS FEELING THE ECONOMIC EFFECTS OF THE WAR IN UKRAINE: INFLATION THAT IS PROVING HIGHER AND MORE PERSISTENT THAN ANTICIPATED AND THE DETERIORATION IN THE EXTERNAL ENVIRONMENT ARE IMPACTING AGENTS' PURCHASING POWER AND CONFIDENCE

Since the spring FSR, the deterioration in the economic outlook has led to a downward revision to growth and an upward revision to inflation. A potential worsening of the effects of the energy crisis, due to severe rationing of gas in Europe, is the main downside risk to Spanish economic growth. However, there are some factors underpinning it, such as the roll-out of the NGEU projects, the gradual disappearance of the global value chain bottlenecks and the expected buoyancy of inbound tourism expenditure.



SOURCES: Banco de España and INE.

a The charts depict the actual GDP and inflation figures up to 2022 Q3 and, from 2022 Q2, the October 2022 Banco de España macroeconomic projections.

flows – could support activity. The roll-out of NGEU projects[3] should support activity in the future, despite something of a delay in their execution. In addition, despite the risks identified, on the latest data global bottlenecks are easing slightly and the baseline scenario envisages their gradual disappearance over the course of 2023. However, the recent improvement in delivery times could be a further symptom of weak global demand. In turn, the resilience of tourism expenditure will also boost activity further.

The outlook for the Spanish economy under the baseline scenario is subject to an extraordinary level of uncertainty and the risks are tilted to the downside. The baseline scenario for Spain envisages inflation easing towards a level close to 2% in 2024 (see Chart 1.3.2). However, a potential escalation of the war in Ukraine, which would trigger greater shocks to European energy supply, could drive energy prices higher still and cause inflation to be more persistent and elevated than anticipated. This would affect agents' confidence and purchasing power, and would have a fresh adverse impact on their spending decisions and on unemployment and

3 See previous footnote.

activity. Under this adverse scenario, monetary policy tightening globally more than expected to date and further disruptions to input supply chains in which Russia and Ukraine are important suppliers – not just of oil and gas, but also of cereals and minerals – would also be more likely. This could adversely affect production in the most exposed sectors of activity.

1.2 Financial markets and the real estate sector

1.2.1 Financial markets

Yields on money markets in advanced economies have continued growing, mainly as a result of the monetary policy tightening and of investor expectations for policy interest rates being raised over the coming months at a faster pace than previously expected. The US Federal Open Market Committee has recently accelerated the scheduled pace of policy interest rate rises, with four consecutive hikes of 75 bp. In the euro area, the ECB Governing Council raised its key interest rates by 50 bp at its July meeting and by 75 bp at its September and October meetings, the largest hike in the euro area's history. This, together with the expectations for further policy interest rate increases in the coming months, has resulted in higher interbank market interest rates. At the cut-off date for this report, the 12-month EURIBOR amounted to 2.7%, some 325 bp higher than at end-2021 (see Chart 1.4.1). In any event, the uncertainty over monetary policy remains very high, as reflected by the increase in the implied volatility of 3M-1Y swaps,[4] which continues above its historical average (see Chart 1.4.1).

Higher policy interest rates and expectations for further increases have also fed through to sovereign debt yields. The upward pattern of yields on these markets has steepened since early August due to increased inflationary pressures and statements from some central banks suggesting that monetary conditions would be tighter than expected. Specifically, the yields on ten-year government bonds reached 4.2% in the United States and 2.4% in Germany, values not seen since 2010 and 2011, respectively (see Chart 1.4.2).

In the euro area, corporate spreads and sovereign debt risk premia increased from late April, but their patterns have been more moderate of late (see Charts 1.4.3 and 1.4.4). Risk premia ceased to rise after the ECB announced it would apply flexibility in its asset reinvestment policy and the approval of the new Transmission Protection Instrument (TPI), whose aim is to ensure the effective transmission of its monetary policy. After widening significantly in June, spreads on corporate bonds

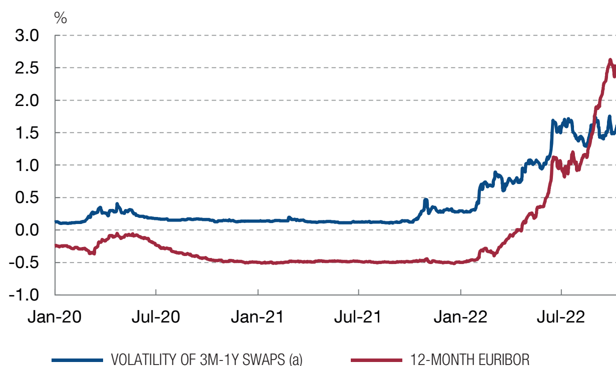
4 Normalised volatility of three-month at-the-money options, whose underlying assets are one-year interest rate swaps that have the 3-month EURIBOR as the floating rate.

Chart 1.4

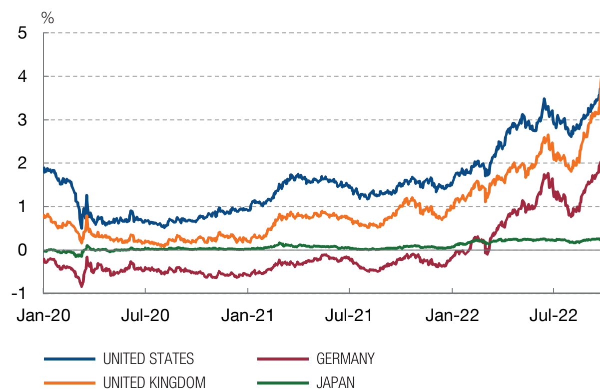
INTEREST RATES ON MONEY AND SOVEREIGN DEBT MARKETS, AND RISK PREMIA ON FIXED-INCOME MARKETS, HAVE CONTINUED TO RISE IN RECENT MONTHS

Yields on money and high-sovereign-rating long-term government debt markets have continued to rise since the last FSR was published, mainly as a result of the tightening of monetary policies and the upward revision to the expected level of policy interest rates. In any event, the uncertainty surrounding monetary policy remains high, particularly in the euro area, as reflected in the implied volatility of 3M-1Y swaps, which stands far above its historical average. Corporate spreads and sovereign debt risk premia in the euro area have increased since April, but their pattern has been more moderate of late.

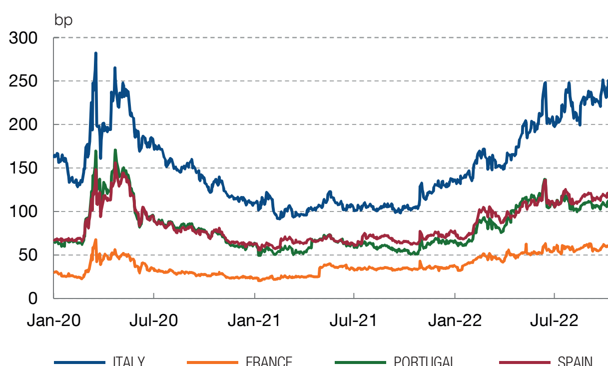
1 EURO AREA: VOLATILITY OF 3M-1Y SWAPS AND 12-MONTH EURIBOR



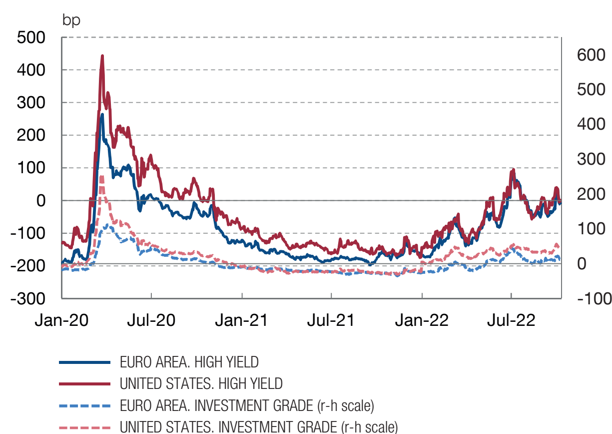
2 10-YEAR SOVEREIGN DEBT YIELDS



3 10-YEAR GOVERNMENT BOND SPREAD AGAINST GERMANY



4 DEVIATIONS FROM THE HISTORICAL AVERAGE OF THE SPREADS ON BONDS ISSUED BY NFCs AGAINST THE SWAP CURVE (b)



SOURCES: Refinitiv Datastream and Banco de España.

a Normalised volatility of three-month at-the-money options, whose underlying assets are one-year interest rate swaps that have the 3-month EURIBOR as the floating rate.

b Deviations calculated vis-à-vis the historical average between 1998 and 2022. High yield: ICE Bank of America Merrill Lynch Non-Financial High Yield Index. Investment grade: ICE Bank of America Merrill Lynch Non-Financial Index.

issued by non-financial corporations have since narrowed, more markedly in the high-yield segment, where they had widened the most at the beginning of the summer.

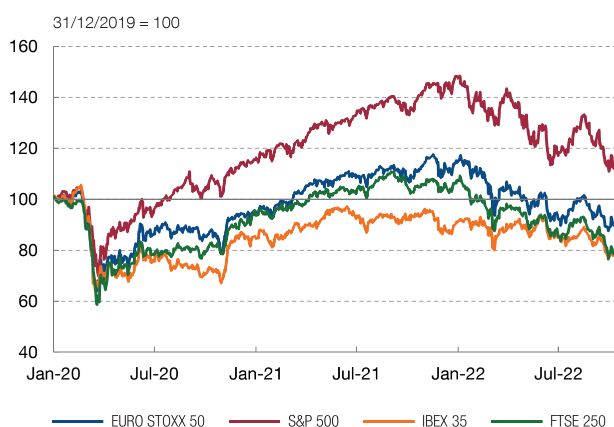
The main stock market indices have recorded declines driven by the rise in long-term interest rates and growing concern about economic developments in different

Chart 1.5

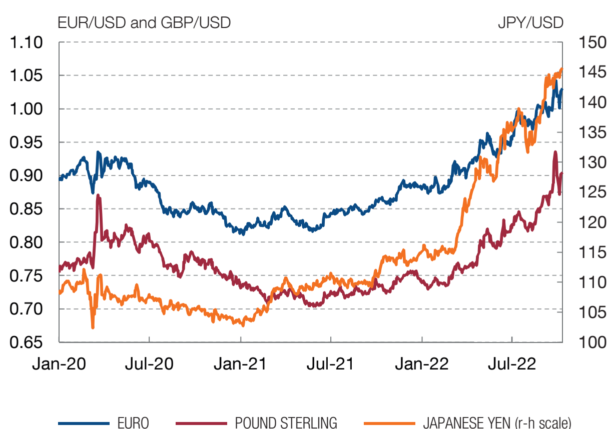
SINCE THE BEGINNING OF 2022 STOCK MARKET INDICES HAVE FALLEN AND THE US DOLLAR HAS APPRECIATED CONSIDERABLY

The main stock market indices have fallen, driven by the rise in long-term interest rates and growing concern about economic developments in different areas. On the foreign exchange markets, the US dollar has appreciated against the main currencies, a development that intensified in the second fortnight of September. This is attributable to actual and expected monetary policy tightening being greater in the United States than elsewhere, the macroeconomic outlook for the United States deteriorating less and the search for safe-haven assets.

1 STOCK MARKET INDICES



2 US DOLLAR EXCHANGE RATES (a)



SOURCES: Refinitiv Datastream and Banco de España.

a An increase (decrease) denotes an appreciation (depreciation) of the US dollar against the other currencies.

areas. The cumulative falls since the last FSR have been similar across the regions. In the United States, monetary policy tightening was more influential, whereas European stock market indices were affected more by the deterioration in the macroeconomic outlook. Since publication of the last FSR, the main stock market indices have lost between 8% and 17% of their value, with the European ones below January 2020 levels (see Chart 1.5.1).

In the foreign exchange markets, the US dollar has appreciated against the main foreign currencies. These changes are attributable to actual and expected monetary policy tightening being greater in the US than elsewhere, the macroeconomic outlook for the United States deteriorating less and the search for safe-haven assets in the face of high uncertainty. The euro is at a 20-year low against the dollar, falling below parity (see Chart 1.5.2). The depreciation of the pound sterling intensified after the previous UK government announced its plan to cut taxes, resulting in the pound sterling falling to its lowest value against the dollar in almost 40 years, nearing parity. The Bank of England's intervention in the bond market, the scrapping of the tax cuts and the change in government have all led to a reversal of most of the pound sterling's depreciation. The Japanese yen is at its lowest level against the dollar since 1998, prompting the Japanese authorities to intervene in the market.

The sharp rise in the prices of some commodities has once again generated tensions in commodity derivatives markets. The escalation of gas and electricity

prices has translated into sharp increases in the amount of collateral required of certain counterparties in clearing houses where such commodity derivatives are settled. This situation has led certain energy utilities that use these contracts for hedging purposes to face difficulties in making these payments. To mitigate these problems and avoid disruptions in the functioning of these markets, several European countries have adopted public measures to support the liquidity of energy firms.[5] The recent drop in energy input prices has alleviated the situation, but we must wait to see whether this trend takes hold and this risk dissipates more definitively.

The downward path of financial asset prices observed in recent months could continue and steepen if certain risk scenarios materialise. Under a scenario in which inflation shows more persistence than expected, monetary policies could be tightened more than anticipated by the markets, triggering a further rise in financial market interest rates. This would have an adverse impact on the price of high credit-rated bonds and on risky assets through the increase in the discount rate implicit in these valuations. The price of these risk-bearing assets could also decline in a scenario of heightened uncertainty and lower economic growth through the adverse effect it would have on firms' expected future profits and/or through the increase in risk premia. These dynamics could be amplified if they were to trigger fire sales by some investors. An area of concern is the existence at the global level of some open-ended investment funds that have increased their exposure to risk in recent years and that have a small share of liquid assets to cover potential departures of participants.

1.2.2 Spanish real estate market

House purchases have continued to show notable strength, although some signs of slowing have been observed in the most recent period. On notarial information, between January and August 2022, housing transactions were slightly more than 30% above those recorded in the same period in 2019 and had reached the highest levels since 2007. These developments were driven by the still favourable financing conditions. However, transactions have waned in recent months (see Chart 1.6.1), in line with the worse economic outlook.

The number of building permits has declined, as has the production of inputs in the construction sector, largely owing to the sharp rise in energy costs, which has visibly pushed up the prices of materials and limited their availability. Thus, housing starts between January and August were just over 8% below those seen in the same period of 2019. There has also been some delay in housing completions, as illustrated by the gap between the number of building permits

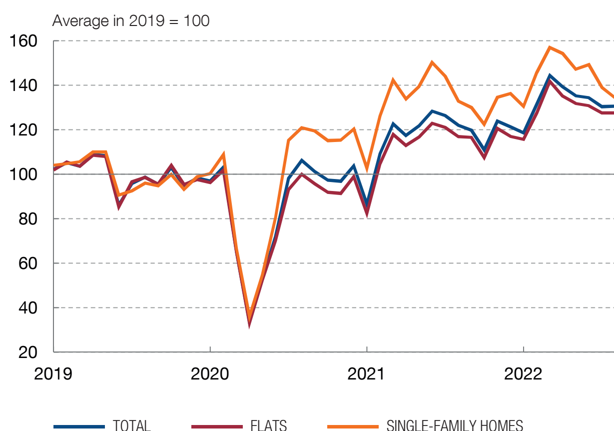
5 On 8 September HM Treasury and the Bank of England set up a £40 billion liquidity fund to support energy firms. The Swedish government announced on 4 September that it would provide electric utilities with up to $23 billion in credit guarantees, while Finland announced a similar package of €10 billion.

Chart 1.6

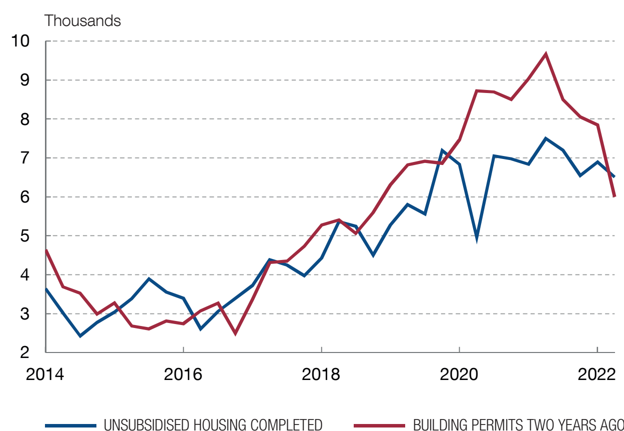
REAL ESTATE ACTIVITY AND PRICES REMAIN EXPANSIONARY, ALTHOUGH THERE ARE CERTAIN SIGNS OF A SLOWDOWN AGAINST A BACKDROP OF DETERIORATION IN THE ECONOMIC OUTLOOK AND GRADUALLY RISING FINANCING COSTS

The number of house purchases has moderated in recent months, but still showed notable growth in the first eight months of 2022 relative to the same period a year earlier. Housing starts and completions posted a shift downwards owing to the higher prices and shortage of materials, high energy costs and growing labour shortages. Against this backdrop, average house price growth moderated to 8% in Q2 which, however, is the second highest growth rate since 2007. There are also signs of diminished dynamism in the prices of some segments of the commercial real estate market.

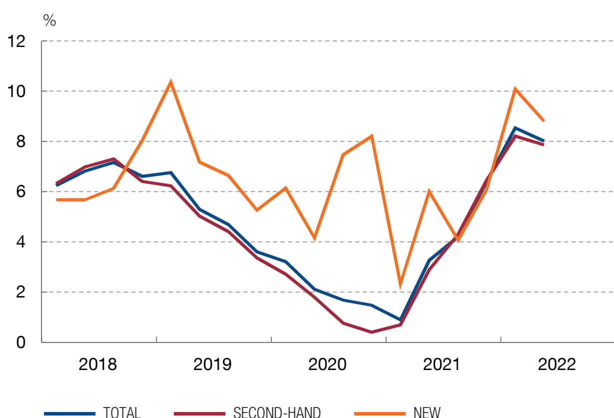
1 NOTARIAL HOUSE PURCHASES (a)



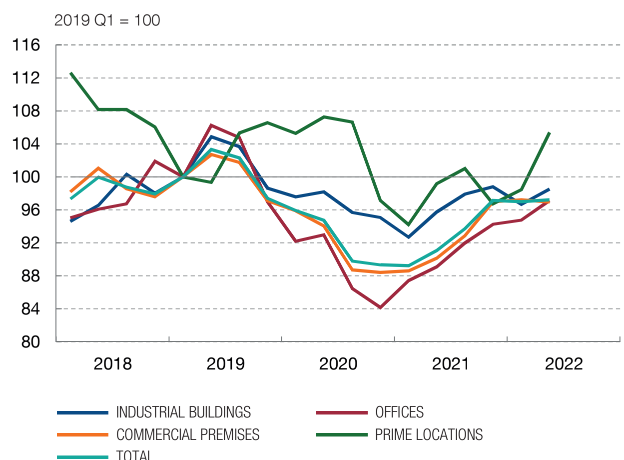
2 HOUSING STARTS (TWO YEARS AGO) AND COMPLETIONS (b)



3 HOUSE PRICES
Year-on-year change



4 COMMERCIAL REAL ESTATE MARKET PRICES (c)



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

a Seasonally and calendar adjusted series. Latest observation: August 2022.

b Seasonally and calendar adjusted series and quarterly average. Building permits granted two years ago are used to depict lagged housing starts. Latest observation: 2022 Q2.

c To calculate these indices each market is divided into strata containing homogeneous properties. A price is then estimated for each stratum based on a hedonic regression model. The indices aggregate the data on the prices estimated for each stratum. The index value for the commercial real estate market as a whole is calculated as an average weighted by the relative share of transactions carried out in each segment. The relative shares per segment are 4% for offices, 78% for commercial premises and 18% for industrial buildings. In 2022 properties in prime locations represent 4% of the transactions conducted in the commercial real estate segment as a whole. Prime location properties include any of the types of properties mentioned above (commercial premises, offices and industrial buildings) that are located in the central business districts of the main large cities (Barcelona, Bilbao, Madrid, Malaga, Palma and Valencia). The data for 2022 Q2 are provisional.

granted two years ago (two years being the average construction time) and the number of houses currently completed (see Chart 1.6.2). The pace of construction is also being affected by growing labour shortages in the sector, as noted by the Banco de España Business Activity Survey (EBAE, by its Spanish acronym).[6]

In line with developments in residential property purchases, new lending for house purchase grew at a brisk pace in 2022 H1, although there are also signs of a slowdown in recent months. In 2022 Q2 the volume of new mortgage loans increased by 10.9% year-on-year, a slightly slower rate of growth than that observed in the final stretch of 2021 (14.8% in 2021 Q4). Despite this notable buoyancy, the stock of mortgage credit hardly grew in 2022 Q2 (1.2%) compared with the same period a year earlier. This was similar to the growth seen in the previous quarters, since the repayment volume has continued to largely offset the amount of the new transactions.

The outstanding balance of credit to the development and construction sector continued to contract in the first half of 2022, in line with the scant momentum of new construction. Specifically, in 2022 Q2 the outstanding balance of this type of credit fell by 6.7% in year-on-year terms, standing at its lowest level for the last 20 years.

Demand for housing continues to outstrip supply and, accordingly, prices have continued to record high growth in Q2, although slightly lower than three months earlier. According to National Statistics Institute (INE) data, the year-on-year growth rate of housing prices moderated to 8% in Q2, 0.5 pp below the increase in Q1 (see Chart 1.6.3). Price rises moderated somewhat in nearly all regions, but were higher than the national average in the islands and along most of the Mediterranean coast. By segment, the price of both second-hand and, to a greater extent, new housing slowed (by 0.3 pp and 1.3 pp, to 7.9% and 8.8%, respectively). Slower growth has also been observed in flats and single-family homes, although the latter continue to record more buoyant growth.

The slowdown in house prices could intensify in the short and medium term. The uncertainty surrounding the economic outlook for agents, their income and the tightening of financial conditions will remain very important factors for the changes in demand for housing and house prices.

There are also signs of diminished dynamism in some segments of the commercial real estate market. In 2022 H1 prices stalled in the commercial premises segment (the one with the highest weight in the aggregate indices) and in that of industrial buildings, interrupting the path of growth observed in 2021 (see

6 See "Encuesta a las empresas españolas sobre la evolución de su actividad: tercer trimestre de 2022", Nota Económica, *Boletín Económico,* 3/2022, Banco de España.

Chart 1.6.4). Conversely, in the office segment and in prime location establishments[7] valuations continued to grow at a notable pace (9% and 6.3%, respectively, in year-on-year terms, in 2022 Q2).

1.3 Non-financial sectors

1.3.1 Non-financial corporations and households

According to Central Balance Sheet Data Office Quarterly Survey (CBQ) data,[8] firms' economic and financial situation continued to recover in 2022 H1, underpinned by the increase in turnover.[9] However, there are signs of deterioration in certain sectors most exposed to the rise in energy costs. Thus, 26.9% of firms posted a negative return on assets (ROA)[10] in 2022 H1, 2.9 pp less than in the same period a year earlier, but still 1.3 pp more than in 2019 H1.[11] By sector, the improvement was stronger in those most affected by the pandemic.[12] Thus, both the proportion of firms with losses and of those with high indebtedness[13] decreased (see Chart 1.7.1). There was also an improvement, albeit more moderate, in the sectors severely affected by the pandemic, which are also highly energy-intensive, such as transport. By contrast, some deterioration in firms' economic and financial situation is now being observed in the sectors most vulnerable to the rise in energy prices and which were not very affected by the pandemic (such as the chemical industry, the manufacture of plastics, the wood industry and the manufacture of basic metals).

Interest rate hikes are raising the degree of financial pressure borne by firms, especially in the case of those with greater indebtedness and with a higher proportion of liabilities whose cost is revised at short term. Until now only a small proportion of the increase in market interest rates has been passed through to the average cost of corporate bank debt, but this process can be expected to intensify in the coming months (see Box 1.2). It is estimated that market interest rate hikes of 300 bp, slightly more moderate than the increases in the 12-month EURIBOR rate recorded since the start of the year (325 bp), will raise indebted firms' median

7 The prime segment refers to any type of commercial premises located in the neighbourhoods with greater commercial activity in Madrid, Barcelona, Bilbao, Palma, Valencia and Malaga.

8 The CBQ comprises a sample of around 1,000 primarily large firms.

9 The State tax revenue service data also point to significant growth in the turnover in 2022 H1, which exceeded that reached in 2019 H1 across all sectors of activity, with the sole exception of the manufacture of transport equipment.

10 Return on assets = (Ordinary net profit + Financial costs) / Net assets (net of non-interest-bearing borrowing).

11 See A. Menéndez and M. Mulino (2022).

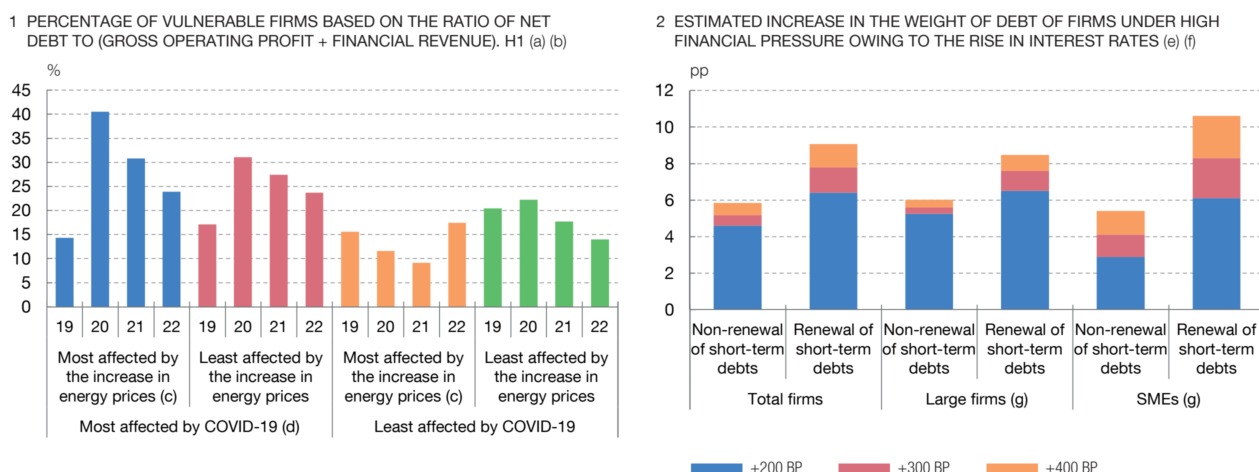
12 The sectors most affected by the COVID-19 pandemic are those whose turnover in 2020 was down more than 15% on 2019. These are: accommodation and food service activities, the manufacture of refined petroleum products, social, cultural and recreational services, transportation and storage, the manufacture of textiles and the manufacture of transport equipment.

13 Firms are understood to be highly indebted when their ratio of Net financial debt to (Gross operating profit + Financial revenue) is higher than 10, or they have positive net financial debt and zero or negative earnings.

Chart 1.7

RISING ENERGY PRICES AND INTEREST RATES ARE NEGATIVELY IMPACTING FIRMS' FINANCIAL POSITION

Firms' income and financial position continued to recover during 2022 H1, particularly in the sectors most affected by the pandemic. However, the rise in energy costs is acting in the opposite direction, especially in the sectors most exposed to this shock and which have not benefited particularly from the end of the health restrictions. Also, once a 300 bp increase in the market interest rate is passed through to the cost of debts renewed in the short term, the weight of corporate debt of firms under high financial pressure will increase by up to 7.8 pp, while a 400 bp hike would have an impact of up to 9.1 pp.



SOURCE: Banco de España.

- **a** Information obtained from the CBQ sample. Data available to 2022 Q2.
- **b** Firms are understood to be vulnerable when their ratio of Net financial debt to (Gross operating profit + Financial revenue) is higher than 10, or they have positive net financial debt and zero or negative earnings.
- **c** The sectors most affected by the increase in energy prices include transportation, mining, basic metals, chemical products and non-metallic mineral products, plastic and fishing.
- **d** The sectors most affected by the COVID-19 pandemic are those whose turnover fell by more than 15% in 2020.
- **e** Firms are considered to be under high financial pressure when their ratio of (Gross operating profit + Financial revenue) to Financial costs is below one.
- **f** In the case of non-renewal of short-term debts, the rise in interest rates is fully fed through to the interest rate on long-term and variable-rate debts and loans. A pass-through of 15% is assumed for sight deposits and of 76% for time deposits for up to one year. The renewal of short-term debts differs from the previous case in that the rise in interest rates is also passed-through to short-term debts and loans.
- **g** Size is defined according to European Commission Recommendation 2003/361/EC.

debt burden ratio by between 2.6 pp and 5.6 pp.[14] Under this scenario, the proportion of total corporate debt of firms under high financial pressure,[15] which stood at 14.1% before this shock, will increase by between 5.2 pp and 7.8 pp (see Chart 1.7.2). No substantial differences in these impacts have been observed by firm size.

The sharp economic slowdown anticipated for the coming quarters could also negatively impact firms' economic and financial position, especially if the

14 The values within this range are obtained based on different assumptions regarding the percentage of debt which matures at short term and is refinanced. The 5.6 pp impact on the upper range assumes the full renewal of the debts maturing in the short term. See Box 3, "An approach to the possible impact of the rise in interest rates on firms' financial position", "Quarterly report on the Spanish economy", *Economic Bulletin* 3/2022, Banco de España.

15 A firm is considered to be under high financial pressure when the ratio (Gross operating profit + Financial revenue) to Financial costs is below one.

aforementioned risk scenarios regarding economic growth materialise. This could further impair their ability to repay their debts. The firms most exposed to this risk are those whose activity is more cyclical, those with a greater share of fixed costs and those starting out from a weaker financial position.

In the case of households and, particularly, lower-income ones, high inflation is raising the level of financial pressure borne. As a result of positive developments in employment in recent quarters, gross disposable income, in nominal terms, has continued to grow, standing in Q2 3.2% above pre-health crisis levels. However, the sharp rise in consumer prices is eroding (especially low-income) households' purchasing power. It is estimated that the average inflation accumulated in 2021 and 2022 will lead to an average increase in indebted households' spending on non-durable goods of 3.9% of their income, the impact being close to 10% in the quintile of lower-income households (see Chart 1.8.1). The evidence available suggests that households that have a more comfortable liquidity buffer[16] are absorbing the impact of inflation by saving less, without changing their spending on other items. Conversely, households with less liquidity (mainly low-income ones) appear to be offsetting the rise in prices by decreasing their spending on non-energy goods.[17]

Compounding this would be the effect associated with the increase in indebted households' financial burden, resulting from higher financing costs. Up to now, the pass-through of market interest rate rises to the average cost of their debt has been modest (see Box 1.2). This pass-through is expected to intensify in the coming quarters, affecting households' ability to repay debts to a greater extent. It is estimated that a 300 bp increase in the 12-month EURIBOR would lead to a rise in indebted households' net financial costs by an amount equivalent to 2.3% of their income, once the conditions of outstanding variable-rate loans are updated (see Chart 1.8.1). This same shock would raise by 3.9 pp the percentage of households with a high net financial burden,[18] to 13.8% (see Chart 1.8.2). All of these effects will tend to be more intense among lower-income indebted households. It should be noted that the 12-month EURIBOR has risen by close to 325 bp in 2022. Therefore, the effect this will have on households' interest burden will be somewhat larger than the aforementioned impacts.

In addition, if some of the economic outlook risk scenarios mentioned above materialise, real household income could decline through an increase in unemployment or a greater persistence of inflation, aggravating households' economic situation. Thus, regardless of their level of income, since March 2022 most

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16 Households that have a more comfortable liquidity buffer are those that have sufficient liquidity (or are able to obtain it) to cover unexpected expenses equal to one month of household income. See the ECB's Consumer Expectations Survey.

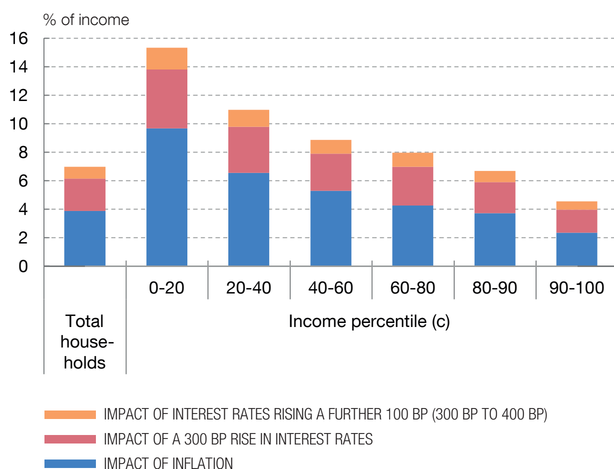
17 See C. Martínez-Carrascal (2022).

18 The net interest burden is considered to be high when the ratio of (Debt service expenses - Interest income from deposits) to Household income is over 40%.

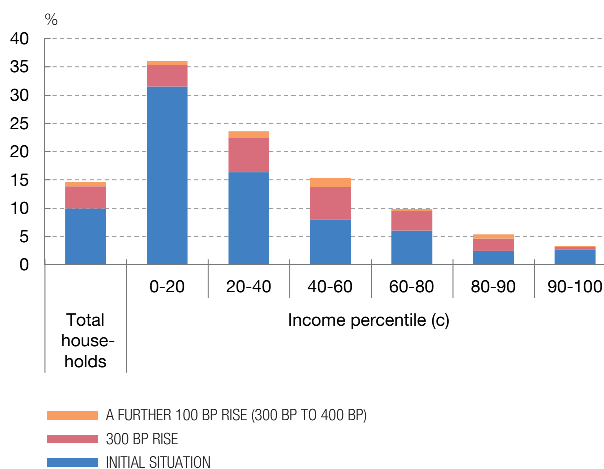
Chart 1.8
INFLATION AND HIGHER INTEREST RATES DETERIORATE TO A GREATER EXTENT THE FINANCIAL POSITION OF LOW-INCOME INDEBTED HOUSEHOLDS

Cumulative average inflation for 2021 and 2022 has increased, on average, indebted households' spending on non-durable consumer goods by an amount equal to just under 4% of their income. A 300 bp increase in market interest rates would increase, on average, the net interest burden by 2.3% of their income. This increase in interest rates would raise the proportion of households with a high net interest burden by almost 4 pp. All these effects would tend to be greater for the lower-income segments.

1 INCREASE IN INDEBTED HOUSEHOLDS' SPENDING ASSOCIATED WITH INFLATION AND HIGHER INTEREST RATES (a) (b)



2 IMPACT OF HIGHER INTEREST RATES ON THE PERCENTAGE OF INDEBTED HOUSEHOLDS WITH A HIGH NET INTEREST BURDEN (b) (d)



SOURCES: Banco de España and Survey of Household Finances (2017).

a The impact of inflation is obtained by multiplying the consumption of non-durable goods by cumulative inflation in 2021 and 2022, calculated as the average of the harmonised index of consumer prices in 2021 (actual figure) and 2022 (forecast in the Banco de España October 2022 macroeconomic projections).
b The impact of the interest rate increases reflects the change in net interest burden (Debt servicing costs - Interest income from deposits). Interest rate increases are assumed to be fully passed through to variable borrowing costs.
c The percentiles are defined for the entire sample of households, regardless of whether or not they are indebted.
d The net interest burden is considered to be high when it exceeds 40% of household income.

households have been expecting their financial position to worsen over the coming twelve months, according to the European Commission's monthly consumer survey.[19] This trend is more pronounced in the bottom income quartile, whose indicator stood at October 2022 at deterioration levels higher than those recorded at the onset of the pandemic, while for the top income quartile this indicator is far from the level observed at that time.[20]

1.3.2 General government in Spain

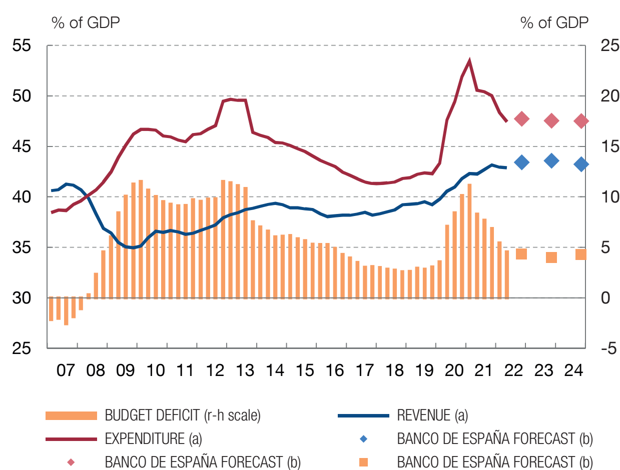
The general government deficit has continued to decline in recent months, driven by the strong growth in receipts (see Chart 1.9.1). The latest available

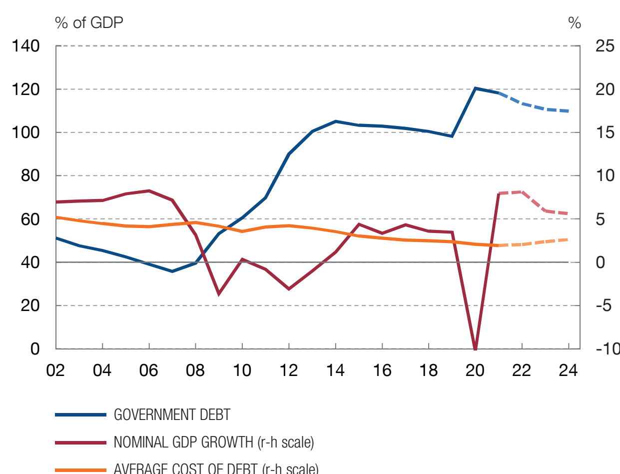
19 The European Commission's monthly consumer survey is available here.

20 The ECB's Consumer Expectations Survey suggests a similar trend. See C. Martínez-Carrascal (2022).

Chart 1.9
THE SPANISH BUDGET DEFICIT CONTINUED TO FALL, ALTHOUGH IN THE ABSENCE OF NEW MEASURES, SPANISH PUBLIC FINANCES WILL REMAIN VULNERABLE IN THE MEDIUM TERM

The budget deficit decreased by 2.3 pp in 2022 H1, to 4.6% of GDP. However, in the absence of new measures, further improvements in the deficit and public debt will tend to tail off, rendering the Spanish economy vulnerable in the medium term to possible future crises and increases in the cost of debt.





SOURCES: IGAE and Banco de España.

a Excluding estimated NGEU funds, which temporarily increase revenue and expenditure, but have no effect on the deficit.
b Taken from the Banco de España's macroeconomic projections published on 5 October 2022.
c The broken lines denote the Banco de España macroeconomic projections for 2022-2024.

information for general government as a whole, which relates to June, shows a general government deficit of 4.6%, down 2.3 pp (in cumulative 12-month terms and as a percentage of GDP) on the figure at end-2021. Receipts performed notably in the first half of the year, continuing to grow at very high rates (above 10% year-on-year). This was bolstered by the recovery in activity and by the impact of the growth of the nominal variables (prices and wages). Nonetheless, the tax take in recent months was again unexpectedly high relative to its macroeconomic determinants, albeit to a lesser extent than in the two previous years. From the start of the COVID-19 crisis in 2020 and excluding the transitory negative impact of the tax cut measures adopted in response to the energy crisis, receipts as a percentage of GDP grew slightly more than 4 pp (see Chart 1.9.1).[21] Expenditure hardly grew in 2022 H1 relative to the same period a year earlier, with the new measures deriving from the war in Ukraine being offset by the absence of certain extraordinary expenses incurred in 2021.[22]

21 Of which only 0.2 pp relate to measures to raise taxes.

22 Such as the extraordinary furlough scheme and suspension of self-employment benefits linked to COVID-19 and the €4.2 billion of estimated losses arising from guarantees granted during the pandemic and allocated in 2021 H1.

In the future other consolidation measures (increase in receipts and/or spending cuts) will be necessary to continue reducing the deficit. The Banco de España's latest projections, published on 5 October,[23] which only incorporate the measures approved until then, point to a deficit of around 4.3% of GDP at end-2022, below the reference value of 5% set by the Government. This is a moderation of the rate of decline in the budget deficit relative to recent months that will remain over the following years, with the budget deficit holding at 4.3% in 2024 (see Chart 1.9.1).[24] Further reductions would require new measures on the receipts or expenditure side, and would benefit from structural reforms enhancing the potential growth of the economy.

In terms of the public debt-to-GDP ratio, nominal GDP growth is expected to offset the general government primary deficit and the changes in the cost of debt up to 2024 (see Chart 1.9.2). Thus, according to the Banco de España's latest projections, the Spanish public debt-to-GDP ratio would decline from the 118.4% recorded in 2021 to a projected 109.9% for 2024. Among the determinants of the changes in said ratio, the general government primary deficit would contribute to an increase of 5 pp. However, this would be more than offset by nominal GDP growth rates remaining relatively high during those years – clearly above the cost of debt – triggering a decline in the public debt-to-GDP ratio.

However, the absence of consolidation measures makes the Spanish public finances vulnerable to possible short or longer-term crises or increases in the cost of debt. The persistence of a structural deficit will continue to exert upward pressure on the level of government indebtedness. This will tend to be exacerbated in the medium and long term owing to increasing social demands related to population ageing and climate change challenges. Also, the positive differential between nominal GDP growth and the cost of debt is expected to narrow, moving towards values close to its historical average. The aforementioned monetary policy tightening and its pass-through to market financial conditions increase the probability of a more unfavourable development in this differential, also in the near term. All of these conjunctural and structural factors will tend to raise the level of public debt and, therefore, reduce the room for manoeuvre with which to address future crises.

The lengthy average term to maturity of public debt and the economic policy instruments available to the European institutions provide some temporary headroom to address the challenges posed by the consolidation of public finances in Spain at the most appropriate time. The Banco de España's latest forecasts already envisage a considerable rise in the interest rates traded on Spanish

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23 See Box 1, "Macroeconomic projections for the Spanish economy (2022-2024)", "Quarterly report on the Spanish economy", *Economic Bulletin* 3/2022, Banco de España.

24 The measures announced together with the Draft State Budget for 2023 do not substantially alter these projections.

debt markets.[25] However, since just over 20% of the debt matures in the next two years and part of it bears interest rates exceeding the current ones, this only translates into an estimated increase of 0.7 pp in the average cost of Spanish public debt between 2021 and 2024.[26] The measures adopted by the European authorities (and, in particular, by the Eurosystem)[27] will also contribute to avoiding situations of disorderly increases in the yields required of Spanish general government by the financial markets.

In the current setting of high inflation and public indebtedness, fiscal policy measures should be targeted and temporary. They should focus on lower-income households, which bear the brunt of inflation, and on the firms most vulnerable to this shock. Moreover, the measures should be temporary to avoid a further increase in the structural budget deficit.

In parallel, a fiscal consolidation process needs to be launched that will help progressively reduce the current fiscal imbalances and gain fiscal space to respond to future shocks. In this regard, it should be borne in mind that the roll-out of investment projects under the NGEU programme already represents an appreciable fiscal stimulus (even if their implementation is experiencing some delays). Thus, the combination of the large-scale use of the European funds – which does not directly affect the budget deficit but does have a positive impact on economic activity – and the commencement of a fiscal consolidation process would make it possible to continue providing some support to economic activity (which may be necessary in a setting in which pre-pandemic GDP levels have not yet been recovered), while gradually reducing the current high structural budget deficit of public finances in Spain.

In any event, it should be noted that offsetting the adverse effects of the current supply-side shock also calls for ambitious policies to boost productivity growth and potential GDP. The role of the NGEU funds could also be particularly important to accompany and finance the necessary structural reforms.

1.3.3 Financial flows vis-à-vis the rest of the world and the international investment position

In 2022 H1 capital inflows to Spain were high (€92 billion), exceeding the net purchases of foreign assets by residents (€80 billion). The main net purchases

25 In the case of the Spanish 10-year bond yield, from 0.3%, recorded on average in 2021, to 3.6%, projected for 2024.

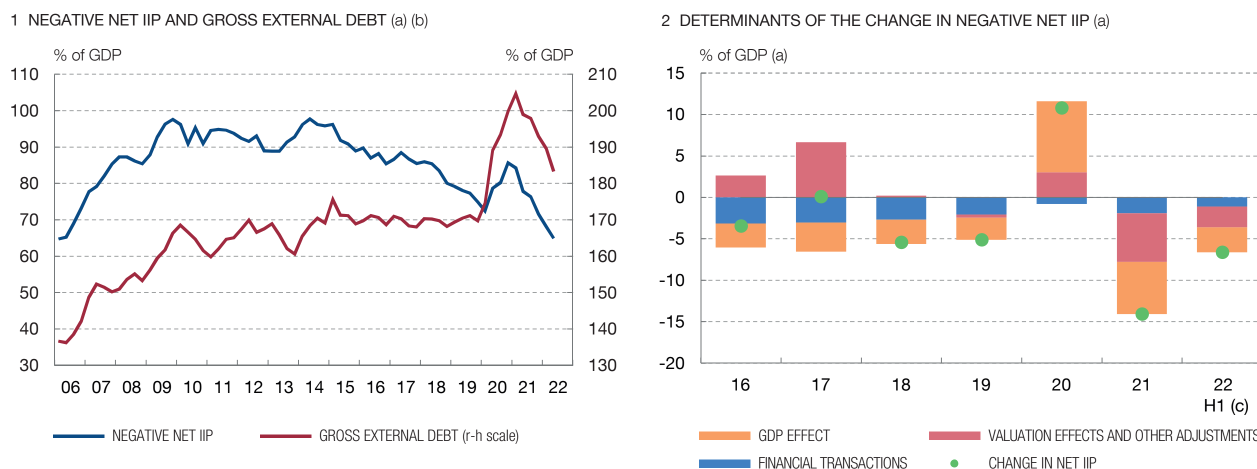
26 An increase of 100 bp in the expected future path of short, medium and long-term interest rates would raise the increase in the average cost of debt in 2024 by a further 0.4 pp, putting the general government's financial burden at 3.1% of GDP at the end of the projection horizon.

27 Including most notably the PEPP portfolio's flexible reinvestment and the new Transmission Protection Instrument (TPI).

Chart 1.10

SPAIN'S NEGATIVE NET IIP AND GROSS EXTERNAL DEBT AS A PERCENTAGE OF GDP HAVE CONTINUED TO CORRECT IN 2022 H1

Spain's negative net IIP continued improving in 2022 H1, reaching 64.9% of GDP, its lowest level since 2006 Q1, as a result of the positive contribution of all its components. Spain's gross external debt decreased slightly in the first half of the year, which, combined with the economic growth, resulted in gross external debt as a percentage of GDP decreasing. However, it remains 13.5 pp higher than the pre-pandemic level.



SOURCE: Banco de España.

a Net IIP is the difference between the value of resident sectors' foreign assets and that of the liabilities to the rest of the world.
b External debt comprises all liabilities that entail a future payment obligation for principal, interest or both (i.e. all financial instruments, except for equities, financial derivatives and monetary gold ingots).
c Calculated as a percentage of cumulative four-quarter GDP.

by international investors were short-term deposits (€68.1 billion), followed by long-term general government debt securities (€28.1 billion) – although those at short term were divested (€17.6 billion) – and direct investment in shares (€11.9 billion).

Spain's negative net international investment position (IIP) continued to correct to 64.9% of GDP in June, the lowest level since 2006 Q1 (see Chart 1.10.1). This ratio is 6.6 pp lower than in December 2021, of which 3 pp are explained by the growth in GDP. Despite its decline, this level is still high from a historical standpoint and far exceeds the European Commission's macroeconomic imbalance alert threshold.[28] In terms of volume, the negative net IIP decreased thanks to the flow of financial transactions with the rest of the world being positive and, especially, to valuation effects and other adjustments (see Chart 1.10.2). The decline in financial asset prices in the international markets penalised the value of residents' holdings abroad, although the depreciation of the euro mitigated this effect to some extent. The decrease in the value of liabilities is mainly explained by the increase in long-

28 The Macroeconomic Imbalances Procedure set up by the European Commission monitors 14 indicators which signal an alert when certain thresholds are exceeded. In the case of the negative net IIP, this threshold is set at 35% of GDP.

term interest rates which reduced the value of (particularly general government) debt securities.

Spain's gross external debt also continued to decline in terms of GDP, although it still stands above pre-pandemic levels. Spain's gross external debt fell by 9.7 pp of GDP in the first half of the year, to 183.3%. The vulnerability which this high external debt entails is mitigated by the composition of liabilities, as a very large share is not repayable at short term, public sector debt predominates and it is mainly denominated in euro and at a fixed rate. However, the increase in market financing costs exacerbates this vulnerability.