1

RISKS LINKED TO THE MACRO-FINANCIAL ENVIRONMENT

The global economy is decelerating against a backdrop of still high inflationary pressures and restrictive monetary policies. The economic growth outlook has tended to worsen in many countries, especially in the euro area and China. Although conditions have improved in the emerging market economies, there are areas of vulnerability in some of the economies to which the Spanish banking system is significantly exposed.

Despite the Spanish economy having shown relatively robust economic growth, it is also facing some weakening. The main sources of risk to growth are related to global economic developments, the effects of monetary policy tightening and geopolitical tensions.

In the financial markets, although risk-free interest rates have continued to rise, risk premia remain very contained, standing at historically low levels. The Spanish real estate market is also being affected by the rise in interest rates, with a pronounced decline in the volume of house purchases and new mortgages; however, house prices are decelerating more gradually for now.

In aggregate terms households' and firms' economic and financial position has evolved favourably over the last two quarters thanks to the buoyancy of income. However, the gradual pass-through of higher interest rates to the cost of debt raises the financial pressure on borrowers. The increase in economic activity is allowing for an improvement in the still high budget deficit and in government debt, which remains an element of vulnerability.

1.1 Macroeconomic environment

1.1.1 Systemic and materially significant countries

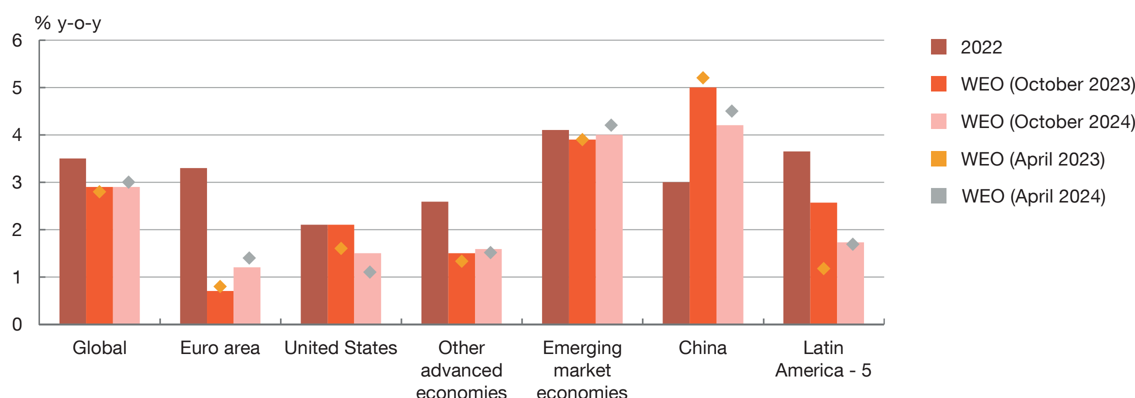
In 2023 to date global economic activity has slowed, while inflation rates have declined. Although GDP grew more than expected in 2023 H1, with positive surprises in certain economies, such as the United States, the latest indicators point to a growing economic weakness, which seems to have passed through from manufacturing to the services sector in H2. The prolongation of the war in Ukraine, the still high inflationary pressures, the consequent restrictive monetary policy stance and the strong deceleration in China remain a drag on global growth.

Since spring, revisions to the global growth outlook for 2023 and 2024 have been heterogeneous across geographical areas (see Chart 1.1.a). For instance,

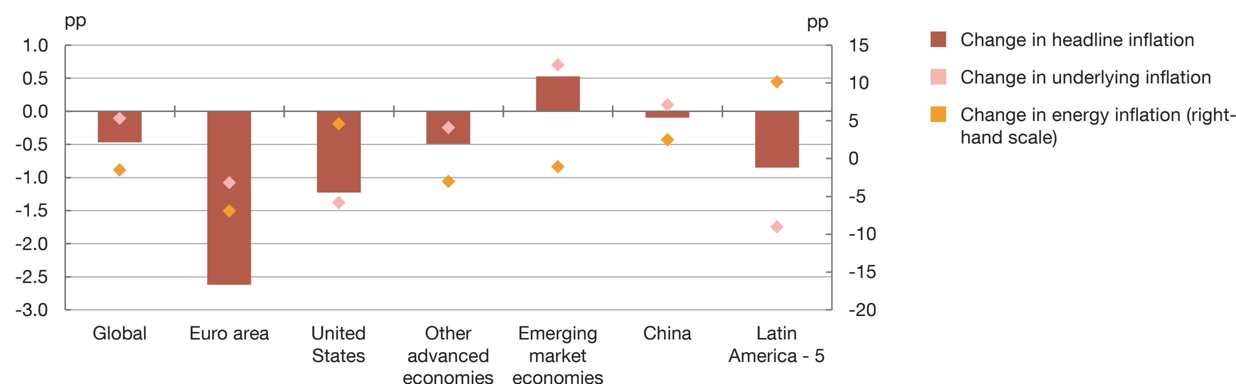
Chart 1.1

Uneven economic slowdown by region and limited correction of underlying inflation rates

1.1.a GDP growth outlook (2022-2024) (a)



1.1.b Change in headline and underlying inflation between April 2023 and September 2023 (b)



SOURCES: IMF, national statistics and Refinitiv.

a WEO projections for October 2023. The diamonds denote the projections for April.

b Inflation is the year-on-year rate of change in the consumer price index. The "Global" aggregate includes the United States, the euro area, the United Kingdom, Japan, Canada, Norway, Sweden, Switzerland, China, India, Indonesia, Malaysia, Philippines, Thailand, Brazil, Chile, Colombia, Mexico, Peru, Czech Republic, Hungary, Poland, Russia and Türkiye. The "Emerging market economies" aggregate includes China, India, Indonesia, Malaysia, Philippines, Thailand, Brazil, Chile, Colombia, Mexico, Peru, Czech Republic, Hungary, Poland, Russia and Türkiye. The "Latin America - 5" aggregate includes Brazil, Chile, Colombia, Mexico and Peru.

forecasts for the United States and Latin America have been revised upwards, owing to the economic buoyancy observed in the two regions. By contrast, in the euro area growth expectations for the two years have been revised downwards, owing to tighter financial conditions, lower external demand and higher energy prices, among other factors. In China, the growth outlook has been revised down notably as a result of the country's real estate crisis (see Box 1.1) and weak domestic and external demand.

Risks to global growth remain skewed to the downside. The risks to activity include those deriving from geopolitical tensions, not only due to uncertainty about the duration and scope of the war in Ukraine and the recent conflict in the Middle

East, but also to the prospects of trade and financial fragmentation along geostrategic lines, which would weigh on global trade and growth. A further tightening of financial conditions, deriving from a deterioration in the inflationary situation, the worse fiscal outlook in some systemically important countries, such as the United States, or higher risk premia, would also adversely affect the global economy.

Risks to inflation are now more balanced. Although headline inflation has decreased (see Chart 1.1.b), the persistence of very high underlying inflation illustrates well the existence of some upside risks. In this connection, low labour market slack (which could lead to greater wage pressures) and the recent rise in energy prices (mainly deriving from supply-side factors, and which could worsen owing to the Middle East conflict) could generate new inflationary pressures. Conversely, factors such as the normalisation of supply chains globally, the tightening stance of monetary policies and the lower global growth expected appear to be acting in the opposite direction.

In the emerging market economies, the financial markets performed relatively favourably in recent months. The improvement was particularly notable in Latin America (see Charts 1.2.a and 1.2.b) for various reasons. First, the region has reached comparatively higher interest rates than other geographical areas during the current contractionary monetary policy cycle, having raised them earlier and higher. This has allowed Latin American countries to contain the depreciation pressures on their currencies arising from monetary policy tightening in the advanced economies. The positive surprises in activity in Brazil and Mexico and the favourable commodity price developments have also contributed to this good performance.

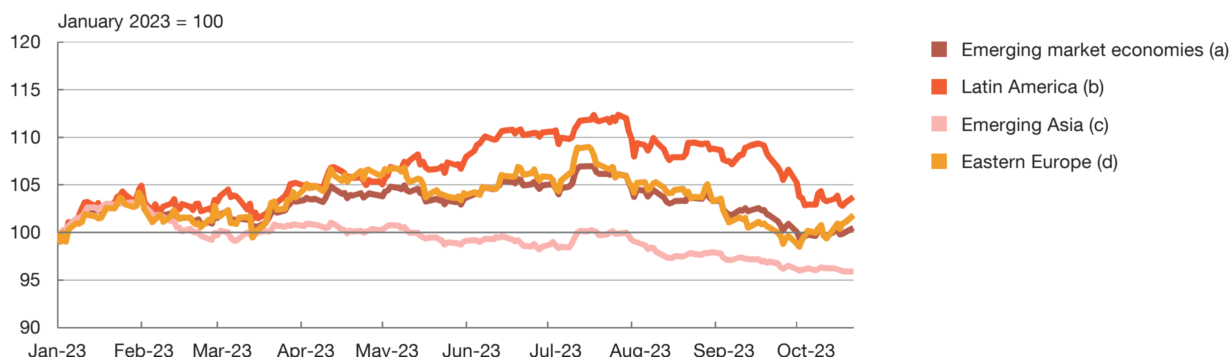
Inflation rates continued to decrease of late in most emerging market economies. However, the decrease has been slower in the last few months, owing to the recent rise in energy prices. Against this background, most central banks have paused their monetary tightening cycles and, in some countries, such as Brazil, Chile, Hungary and Poland, they have even started to cut their policy rates. However, in Russia and Türkiye interest rates were raised substantially to contain inflationary pressures.

In any event, the risks to growth in the emerging market economies remain tilted to the downside. The fact that their monetary policies are not synchronised with those of the advanced economies could lead to a depreciation of most of these countries' currencies against the dollar and less favourable capital flow trends. Lower than expected growth in the main advanced economies would reduce the external sector's contribution to GDP growth. Conversely, the recent rise in energy and food prices could particularly affect the disinflation process in the emerging market economies, given the greater relative weight of these components in their consumption baskets. Lastly, in some emerging market economies there are risks deriving from political tensions and economic policy uncertainty. The main

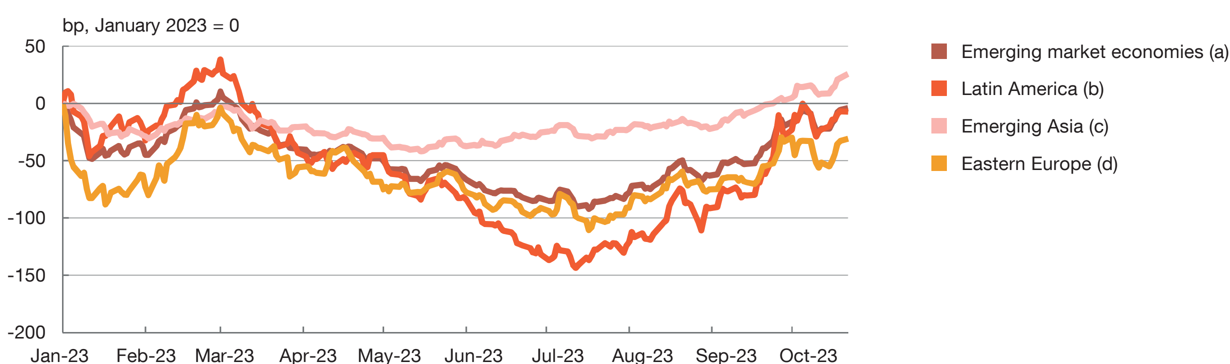
Chart 1.2

The financial markets performed favourably in the emerging market economies

1.2.a Exchange rates against the dollar. An increase indicates appreciation against the dollar



1.2.b Change in long-term government bond rates in local currency



SOURCES: Refinitiv and national statistics.

a Average for the three regions represented.
b Simple average for Brazil, Mexico, Chile, Colombia and Peru.
c Simple average for China, South Korea, Malaysia, Philippines, Thailand, India and Indonesia.
d Simple average for Czech Republic, Hungary, Poland, Russia and Romania.

vulnerabilities of the emerging market economies to which the Spanish banking system is significantly exposed are reviewed below.

Economic activity in Mexico has surprised on the upside, amid a favourable performance from its banking system. The Mexican economy grew more than expected in 2023 H1. Despite headline inflation trending downwards recently, underlying inflation remains very high, above the headline figure. Against this backdrop, the central bank has maintained the policy rate at 11.25% since March 2023 (after a cumulative increase of 725 basis points (bp) since June 2021). The Mexican banking system's capital and liquidity levels are holding above the regulatory minimum and lending to the private sector remains buoyant. As regards other risks, a credit rating agency downgraded the rating for the State-owned oil company, PEMEX, highlighting that this could be detrimental for Mexico's sovereign debt rating.

In the case of Brazil, headway has been made in the fiscal area, where its main economic vulnerabilities lie. Brazil's economic activity also surprised on the upside in H1, while inflation continued to decrease, albeit not consistently. In August the central bank initiated a monetary easing cycle that has been reflected in two 50 bp policy rate cuts (to 12.75%), while setting an inflation target of 3% and making progress in fiscal reforms, with the approval of a new fiscal rule and a tax reform. This reinforcement of the country's institutional framework led to a favourable financial market performance and a one-notch upgrade in the sovereign rating, the first since 2009. Although the risks to the Brazilian economy may be considered more balanced now, some fiscal and financial risks persist. These include the use of the State-owned oil company to contain the rise in energy prices and to boost public investment, or of public banking to finance a new medium-term investment plan.

Türkiye has pivoted towards more orthodox economic policies following the presidential elections. Turkish economic growth remained strong in 2023 H1, fuelled by ever-more expansionary fiscal and monetary policies that exacerbated the existing imbalances, such as very high inflation (close to 40%) and a bloated current account deficit. However, following the May elections, the authorities have turned to fiscal adjustment measures and a more restrictive monetary policy, with interest rate hikes between June and September of 1650 bp (to the current 25%). Additionally, the central bank has introduced some measures to curb credit growth and initiated a regulatory streamlining process (for instance, with measures aimed at phasing out foreign exchange-protected deposits). Interventions in foreign exchange markets have also been reduced substantially to replenish international reserves and allow for an exchange rate adjustment, although this has led to a depreciation of the Turkish lira against the dollar of nearly 30% and a fresh pick-up in inflation in recent months. The adjustment programme faces notable challenges in the current highly uncertain macro-financial environment.

1.1.2 Spain

Spain's economic growth has slowed substantially over the course of the year, owing to global economic activity losing momentum after the post-pandemic recovery and the cumulative impact of strong price increases and interest rate hikes. After rising by 0.6% and 0.5% in Q1 and Q2, respectively, Spain's GDP grew at a slower pace between July and September, according to the latest Banco de España projections (see Chart 1.3.a).[1] The latest information suggests activity will remain relatively weak in Q4.

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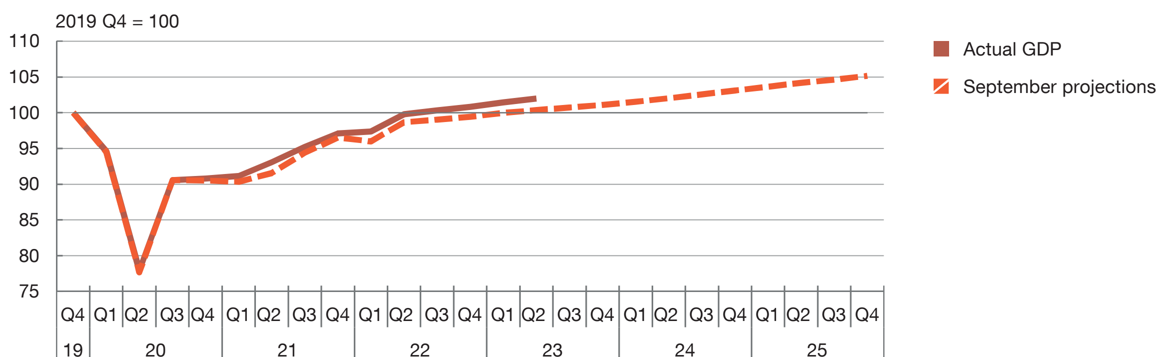
1 For further details, see "Macroeconomic projections for the Spanish economy (2023-2025)". In "Quarterly report and macroeconomic projections for the Spanish economy. September 2023". In *Economic Bulletin - Banco de España,* 2023/Q3. These projections were published on 19 September, when the revised series of the Quarterly National Accounts up to 2023 Q2, which were published by the National Statistics Institute (INE) on 22 September, were not yet available. When the projections were prepared, the year-on-year GDP growth for 2023 Q1 and Q2 stood at 0.5% and 0.4%, respectively, with both figures subsequently revised up by 0.1 pp. The growth projected at that time for Q3 was 0.3%.

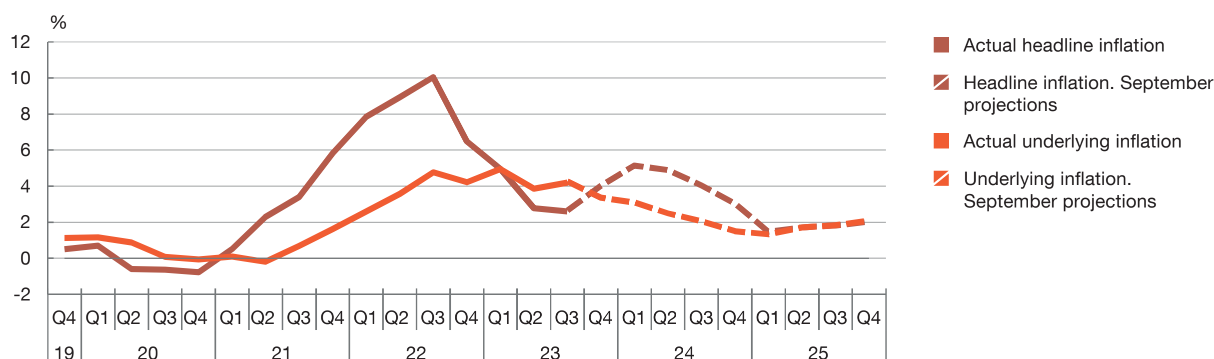
Chart 1.3

Although the Spanish economy will slow down in 2023 H2, it will subsequently gain some momentum, while underlying inflation declines

1.3.a Real GDP. Spain. Level (a)



1.3.b Headline and underlying inflation (a)



SOURCES: INE and Banco de España.

a The charts depict the actual GDP and (headline and underlying) inflation figures, respectively, up to 2023 Q2 and Q3, and from then on the September 2023 Banco de España macroeconomic projections. The latest GDP series available at the time these projections were drawn up was that published by the INE on 28 July 2023, which included the flash estimate for 2023 Q2. The definitive inflation figure for 2023 Q3 was not available at that date either. On 22 September 2023 the INE published revisions to the quarterly GDP profile from early 2020 to 2023 Q2 and subsequently published the final inflation data relating to September. Underlying inflation excludes the energy and food components.

Overall, in 2023 GDP is set to grow by 2.3% according to the Banco de España projections published in September.[2] This increase would be lower than that observed a year earlier (5.8%).

In addition, the Spanish economy is showing greater momentum than the euro area as a whole. This is mainly due to the greater relative importance of services linked to tourism within Spain's productive structure. In recent quarters, these sectors have shown greater rates of activity than others (such as manufacturing) that

2 Following the revision of the National Accounts data, automatically and without any additional consideration, the average GDP growth rate for 2023 would be 0.2 pp higher.

have been hampered by the slowdown in the Chinese economy (whose weight in the Spanish economy is comparatively low).

Under the baseline projection scenario, from 2024 activity would gain momentum somewhat, despite some factors having a slight dampening effect. The factors supporting this greater growth are related to the gradual recovery in the external environment and agents' confidence, the relative strength of the labour market and the more rapid roll-out of investment projects associated with the Next Generation EU (NGEU) programme. Nevertheless, other factors may dampen the Spanish economy's momentum once the pre-pandemic level is exceeded. Such elements include the still incomplete pass-through of monetary policy tightening to the cost of funding, the withdrawal of the government measures rolled out to tackle the energy crisis and the lower contribution to aggregate growth of foreign tourist expenditure. Indeed, some of these factors may have already started to make themselves felt in recent quarters. Thus, the outlook for GDP growth in 2024 (1.8% according to the latest projection exercise) is 0.5 pp lower than that set out in the previous financial stability report (FSR).

The uncertainty surrounding the outlook for the Spanish economy under the baseline scenario is still very high, with downside risks to activity and balanced risks to inflation. The main sources of risk arise from a potential worse performance of global economic activity (for instance, owing to a more pronounced slowdown in the Chinese economy) and to the effects of the cumulative monetary policy tightening being potentially more negative than those envisaged under the baseline scenario, which in turn would lead to lower inflation levels. In addition, the risk of a flare-up in geopolitical tensions, which are expanding across several areas of the planet, persists. Their materialisation would lead to greater inflation and a worsening of the economic outlook.

1.2 Financial markets and the real estate sector

1.2.1 Financial markets

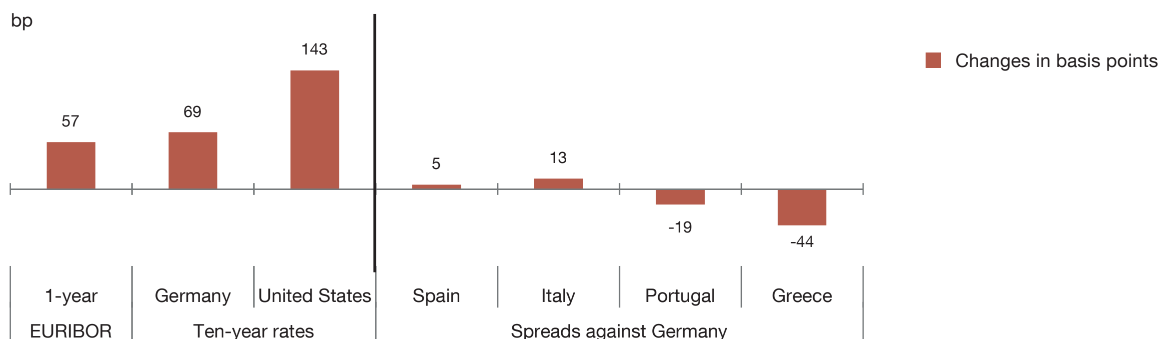
The interbank market

Since the cut-off date for the last FSR, money market rates in the advanced economies have continued to rise as a result of monetary policy tightening. Since April, the Governing Council of the European Central Bank (ECB) and the Federal Open Market Committee (FOMC) have raised policy rates by 100 bp (four 25 bp hikes) and 50 bp (two 25 bp raises), respectively. Thus, at end-October the main policy rates[3] stood at 4% in the euro area and in the 5.25% - 5.5% range in the

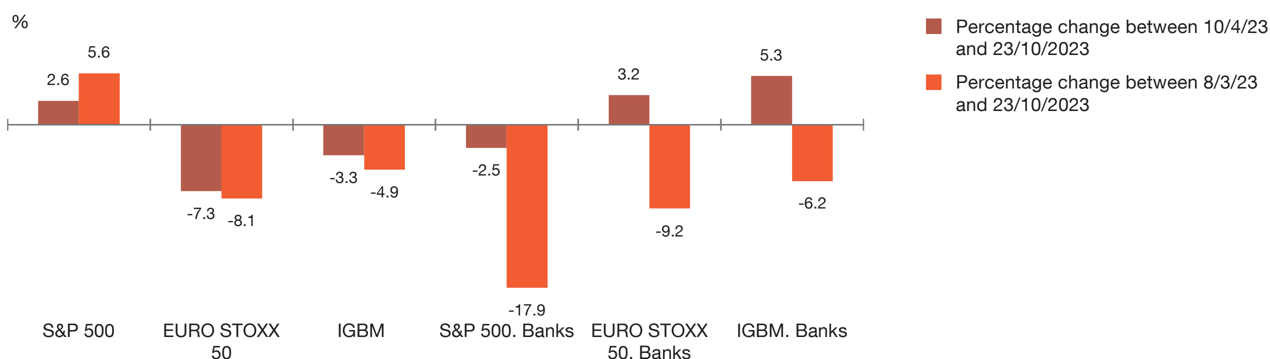
3 The deposit facility rate in the case of the ECB, and the federal funds rate in that of the United States Federal Reserve System.

Chart 1.4
Financial conditions include higher interest rates

1.4.a EURIBOR and 10-year sovereign debt. Change in basis points between 10/4/23 and 23/10/2023 (a)



1.4.b Stock market and sectoral bank indices (b)



SOURCE: Refinitiv Datastream.

a The date 10/4/23 relates to the cut-off date for the last FSR.
b The date 8/3/23 relates to the day preceding the start of the episode of turmoil in the banking sector.

United States, restrictive levels that could be close to the terminal rate for this monetary policy tightening cycle. They could remain at that level for a lengthy period according to the monetary authorities' communications, as well as current analyst forecasts and financial market expectations. In line with this, at the cut-off date of this report the 12-month EURIBOR stood at 4.1%,[4] i.e. 57 bp higher than in early April 2023 (see Chart 1.4.a).

Sovereign and corporate debt

Long-term yields on higher-rated sovereign debt also rose. The rise in rates in the long-term debt securities market has been particularly steep since early September and has been influenced both by changes in inflation expectations and

4 As at 23 October.

the effects of inflation on the future course of monetary policies and by the increase in the long-term premium as a result of greater uncertainty about how interest rates will change. This increase seems to have been led by the US sovereign debt market, given its significant role in determining the prices of these assets globally. At the cut-off date for this report, ten-year sovereign bond yields stood at 2.9% in Germany, 4.9% in the United States and 4.6% in the United Kingdom, up by 69 bp, 143 bp and 117 bp, respectively, since the cut-off date of the last FSR. Secondary market liquidity, having deteriorated in some jurisdictions (such as Italy) from late September 2022, now stands, overall, at levels similar to those of April 2023 for European sovereign debt issuers overall.

Sovereign and corporate risk premia have remained contained compared with the levels in early April. Since early September, the increase in long-term risk-free rates, with a negative impact on debt sustainability, seems to have contributed to a slight increase in the long-term sovereign spreads against the German benchmark during this period in euro area countries with high levels of public debt. However, since the cut-off date of the last FSR, the Portuguese sovereign spread has dropped to 69 bp, widening the gap to the Spanish spread. The Greek risk premium, which is already below the Italian one, also decreased, and more markedly. This decrease was influenced, in part, by DBRS and Standard & Poor's upgrading its credit rating to investment grade.[5] For their part, since September the corporate spreads relative to the swap curve have also increased (more intensely in the high-yield segment) as a result of the increase in long-term interest rates. The levels reached are slightly higher than those recorded in early April in Europe and somewhat lower than in the United States, in line with the relatively better performance of the US economy compared with that of the euro area. As regards the issuance of debt securities by non-financial corporations, in the year to date investment grade and high-yield volumes stood at levels slightly above those for the same period in 2022, both in the United States and in the euro area.

Equities and exchange rates

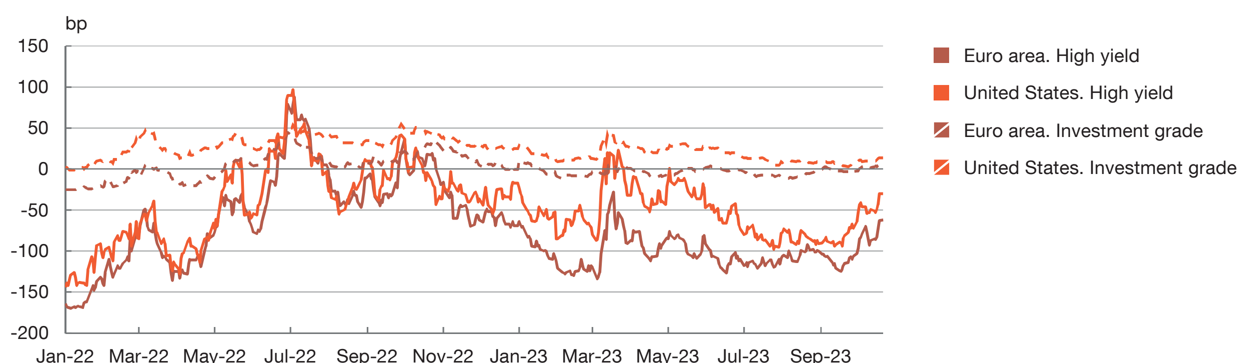
The stock market indices of the main developed economies have shown high geographical and sectoral heterogeneity since the last FSR. European stock market indices recorded declines in general, while US stock prices were supported by positive corporate earnings. However, the sharp increase in long-term interest rates, especially since September, seems to have affected the prices of equities negatively, particularly in some high-growth sectors, insofar as these increase the discount rate for future dividends. By contrast, the higher interest rates appear to be

5 Both DBRS and Standard & Poor's raised the Greek sovereign debt rating to investment grade on 8 September and 20 October, respectively, and Moody's raised its rating by two notches on 15 September, just one level below investment grade. Fitch will revise Greece's credit rating at end-2023; some analysts suggest it will be upgraded to investment grade.

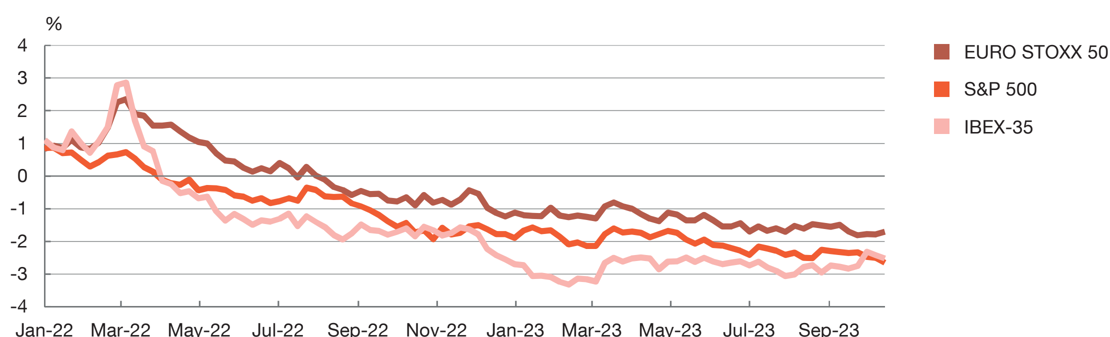
Chart 1.5

By historical standards, corporate bond and equity risk premia are at low levels

1.5.a Differentials between NFC bond yields and the swap curve. Deviations from a historical average (a)



1.5.b Equity risk premium. Deviations from a historical average (b)



SOURCE: Refinitiv Datastream.

a High yield: ICE Bank of America Merrill Lynch Non-Financial High Yield Index. Investment grade: ICE Bank of America Merrill Lynch Non-Financial Index. Deviations are calculated vis-à-vis the historical average between 1998 and 2023. The average is 454 bp for euro area high-yield bonds, 446 bp for US highyield bonds, 78 bp for euro area investment grade bonds and 131 bp for US investment grade bonds.

b The equity risk premium is calculated using a two-phase dividend discount model. For further details, see Russell J. Fuller, and Chi-Cheng Hsia (1984), "A simplified common stock valuation model", Financial Analysts Journal. The historical averages are calculated for the period 2006-2023. The average is 6.62% for the EURO STOXX 50, 5.00% for the S&P 500 and 7.89% for the IBEX 35.

boosting banks' profits and, accordingly, their stock market prices (see Chart 1.4.b). Nevertheless, in the United States uncertainty about regional banks' position remains after Moody's and Standard & Poor's downgraded some of their credit ratings in August. This had an adverse effect on the sector's stock prices – still well below the level prior to the turmoil in March –, while those of the European banking sector, which has not yet fully recovered, are closer to this level.

On the foreign exchange markets, the US dollar has appreciated significantly against the main currencies since mid-July 2023. This could be a reflection of the widening of the positive interest rate spread in the United States relative to other areas and of the relative improvement in the economic growth outlook for the United States compared with other advanced economies, such as the euro area.

Risks to financial stability

The materialisation of certain macroeconomic risks could trigger corrections in financial asset prices, particularly for higher risk assets. First, upside inflation surprises could lead the market to revise up its expectations on the future course of policy rates. This could boost long-term yields even more and lower the prices of risky assets, such as corporate bonds and shares. Second, a worse than expected economic outlook could also drive down asset prices through its adverse effect on firms' expected earnings and through its impact on risk premia. In addition, the relatively low equity and corporate risk premia (especially in the lower credit quality segment), which are below their historical average, drive up the probability of (i) such price corrections occurring and (ii) them being more pronounced, should adverse shocks materialise (see Chart 1.5).

Dynamics with potentially adverse implications for financial stability could arise in the event of disorderly price corrections. Thus, asset prices could fluctuate widely if fire sales were triggered by some investors, such as those specific open-ended investment funds that have a small share of liquid assets to cover potential investor outflows. Provisioning needs for derivatives transactions could also increase, raising the risk-free asset interest rate.

1.2.2 The Spanish real estate market

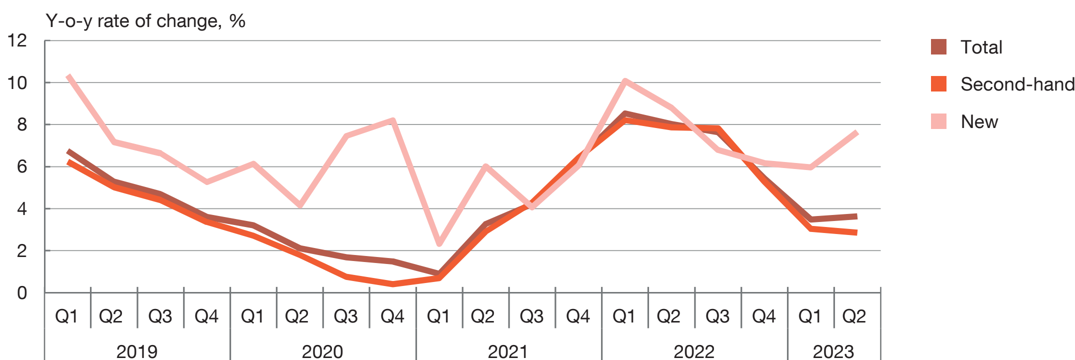
A substantial slowdown in house prices remains, compared with the momentum observed in 2022, although a slight increase has been recorded in 2023 Q2. According to the National Statistics Institute (INE), house prices picked up in Q2, recording year-on-year growth of 3.6%, 0.1 pp higher than three months earlier (see Chart 1.6), but 4.4 pp lower than in 2022 Q2. This increase is mainly explained by the rising path of new house prices, which could reflect, among other factors, the scarcity in the supply of housing and the pass-through of the past sharp increases in construction material costs. New house prices grew by 7.7% year-on-year, only 1.1 pp less than a year earlier. By contrast, second-hand house prices slowed, recording year-on-year growth of 2.9%, down 0.2 pp on the previous quarter and down 5 pp on 2022 Q2.

House purchases have dropped from the high levels seen in 2022. Transactions registered before notaries saw a year-on-year drop of around 15% in Q2 and it appears that the fall persisted, going by incomplete data for Q3 relating to August. However, these year-on-year declines are affected by the high volume of transactions in 2022 (see Chart 1.7.a). The average cumulative number of transactions so far in 2023 is slightly more than 13% above the level recorded in the same period in 2019.[6]

6 For more information on the factors behind recent trends in housing supply and demand, see Lucio San Juan (2023). "The housing supply and demand mismatch and its relationship with house prices". *Economic Bulletin - Banco de España,* 2023/Q2, 09.

Chart 1.6
House prices continued to rise, although at a slower pace, driven by the new housing segment

1.6.a House prices



SOURCE: INE.

The easing of the pace of growth in economic activity and rising borrowing costs are expected to continue to check momentum in house sales in coming quarters.

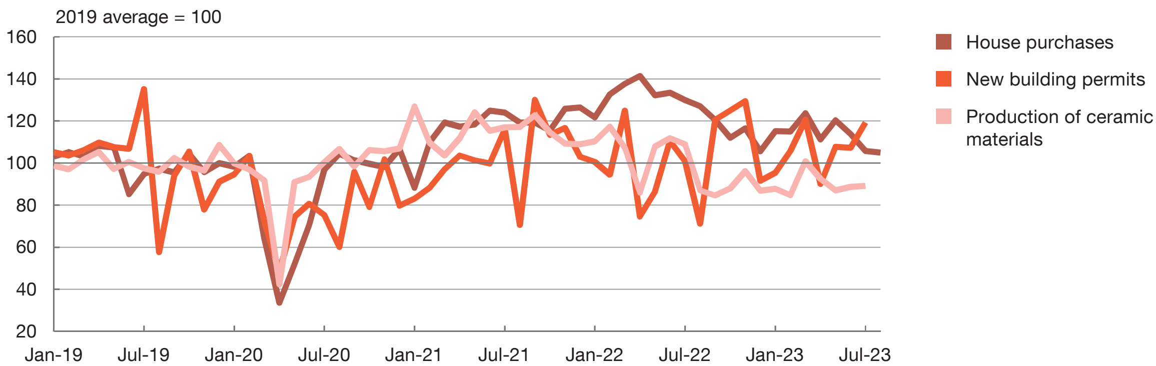
The volume of new mortgages also dropped significantly in 2023 H1, although it remains above pre-pandemic levels. New mortgage volume fell by 21.8% and 26.3% year-on-year in 2023 Q1 and Q2, respectively, compared with a drop of 5.5% in 2022 Q4. Once again, the extent of the year-on-year fall can be partly explained by the high levels of the previous year. New mortgage approval rates remained above pre-pandemic averages (see Chart 1.7.b). The sharper contraction in the volume of new lending relative to housing sales is a reflection not only of decreased reliance on borrowing to finance housing purchases, but also a fall in the average value of mortgages relative to house prices.

The fall in the volume of new lending and the high rate of repayments have steepened the downward trend in the outstanding amount of mortgages. Specifically, in 2023 Q2 the outstanding balance of mortgages stood 2.6% below that of the same period in 2022, as shown in Chart 1.7.b. This decline is the result of not only weaker new lending, but also the high mortgage repayments volume, driven by the incentives created by rising interest rates on variable rate loans and low interest rates on deposits in an environment in which fees for these types of transactions have, for the moment, been removed.[7] It is estimated that the total volume repaid in 2023 H1 represented 6% of the outstanding balance of mortgages, compared with 5% in the same period a year earlier.

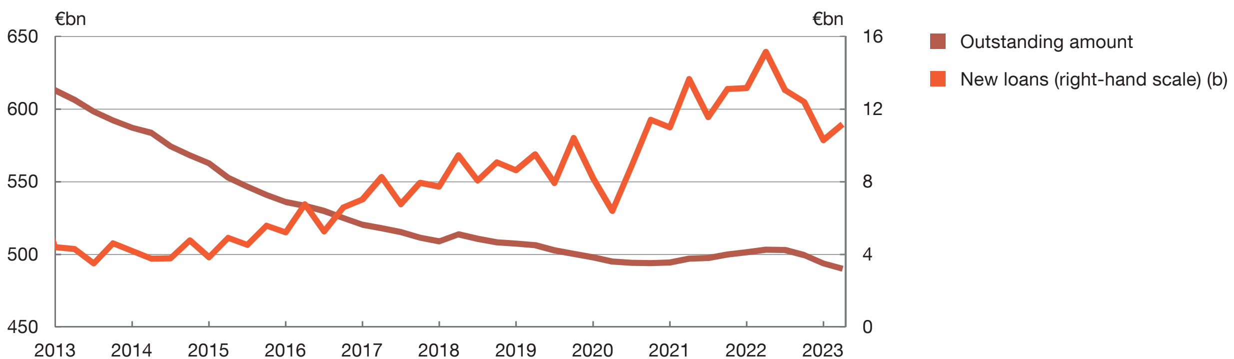
7 Royal Decree-Law 19/2022, of 22 November 2022, stipulates that early repayment fees shall be waived for variable-rate mortgages during 2023.

Chart 1.7
Residential real estate activity and mortgage loans ease

1.7.a Indicators of activity in the residential real estate sector (a)



1.7.b Volume of mortgages for house purchase



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

a Seasonally adjusted series. Latest observation: house purchases (August 2023) and manufacture of ceramic materials and new building permits (July 2023).
b Volume of loans granted in each quarter.

Lending to the construction and development sector also continued to fall. The year-on-year drop in Q2 was 4%, compared with 3.6% in Q1 and 7.7% at end-2022. As noted in previous FSRs, this portfolio has been in decline since the global financial crisis, limiting the banking sector's exposure to disruptions in this market.

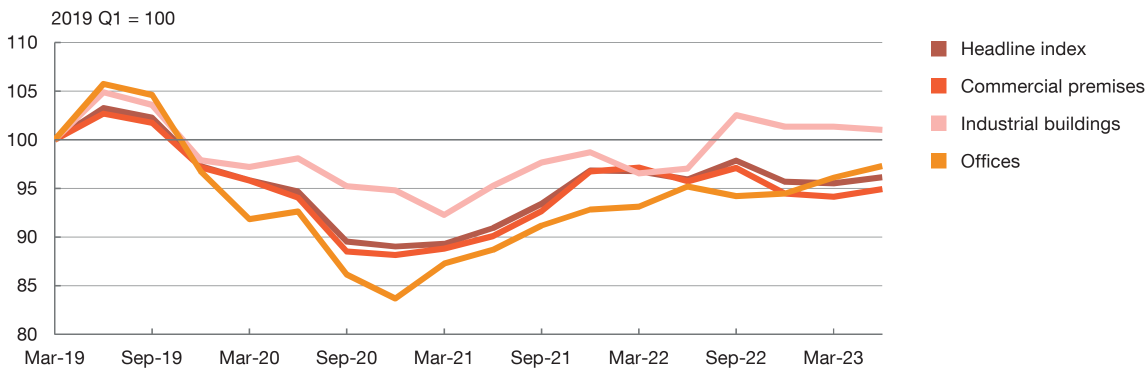
Turning to construction permits, there was a rebound over the course of the year and production of inputs in the construction sector has been plateauing in recent months. The easing of material supply problems, which has come at the same time as a halt in their rising costs, has fostered these developments. In any case, still-high material costs, scarce labour availability in the sector and rising borrowing costs continue to encumber housing starts, which remain at historically low levels.

Commercial property prices picked up somewhat in 2023 H1, unevenly across segments. The overall index for commercial property prices rose slightly in 2023 H1

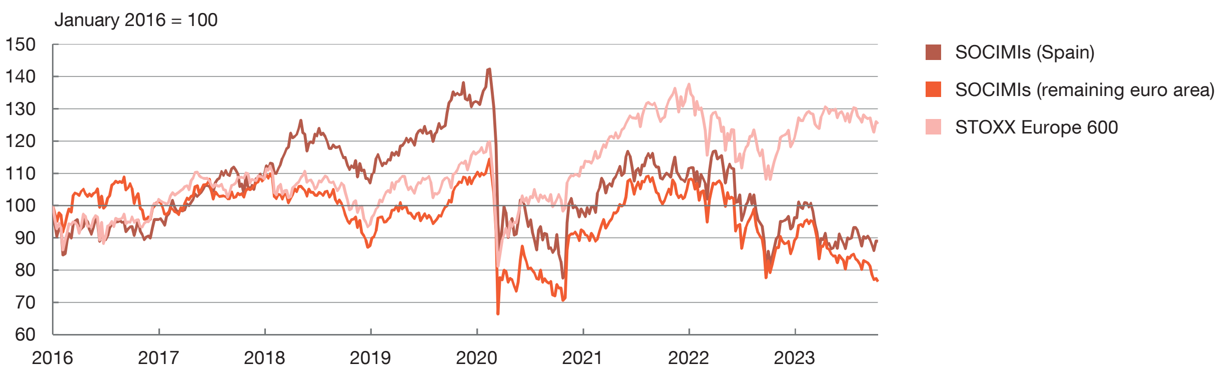
Chart 1.8

The price of commercial property picked up slightly in 2023 H1, but the correction in the sector's stock prices continues

1.8.a Commercial real estate sector price indices (a)



1.8.b Listed real estate investment companies (SOCIMIs) (b)



SOURCES: Datastream (Refinitiv) and Banco de España.

a Based on a hedonic regression model for each stratum. The aggregate index is the average weighted by the relative share of transactions carried out in each segment (4% for offices, 78% for commercial premises and 18% for industrial buildings). In 2022 properties in prime locations, i.e. those located in central areas of the main large cities (Barcelona, Bilbao, Madrid, Málaga, Palma and Valencia), represented 4% of transactions conducted in the commercial real estate segment as a whole.

b SOCIMI indices are based on a selection of firms of this type that are quoted on markets with a certain frequency and have a listed history going back to 2016. Most SOCIMIs in the group "SOCIMIs (remaining euro area)" are based in France. The Spanish SOCIMIs included under "SOCIMIs (Spain)" represent around 10% of the stock market value of SOCIMIs listed in the euro area.

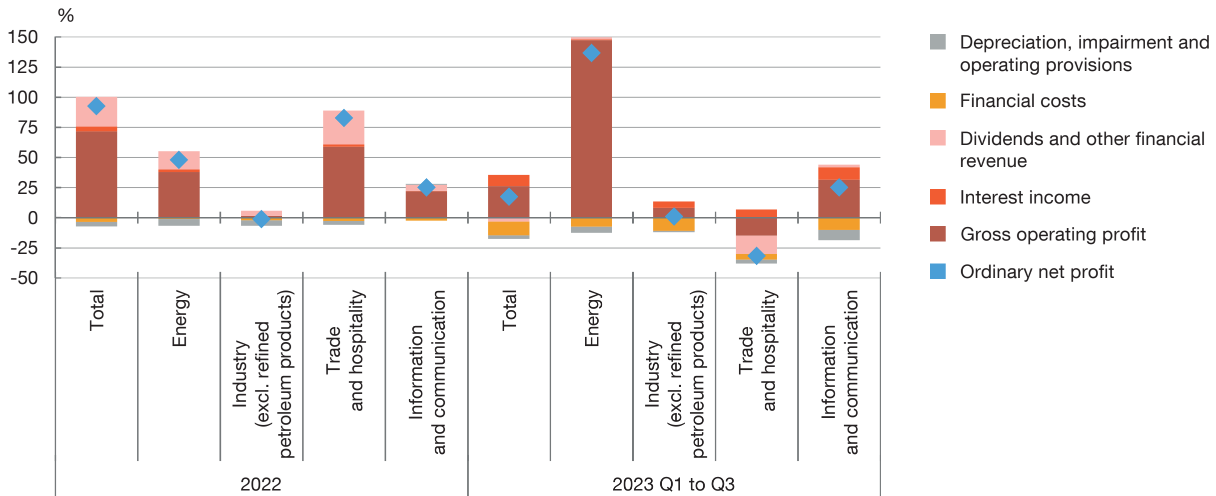
(by 0.5% since 2022 Q4), following the drop seen at end-2022. By segment, prices rose for commercial premises, especially for offices, while industrial building prices fell slightly in this period (see Chart 1.8.a).[8] The market price of Spanish listed real estate investment companies (SOCIMIs, by their Spanish acronym) has stabilised in recent months, although it remains well below levels seen in early 2022. This is consistent with the performance of European firms of this type (see Chart 1.8.b).

8 Offices and industrial buildings account for a much smaller share of the general index than commercial premises.

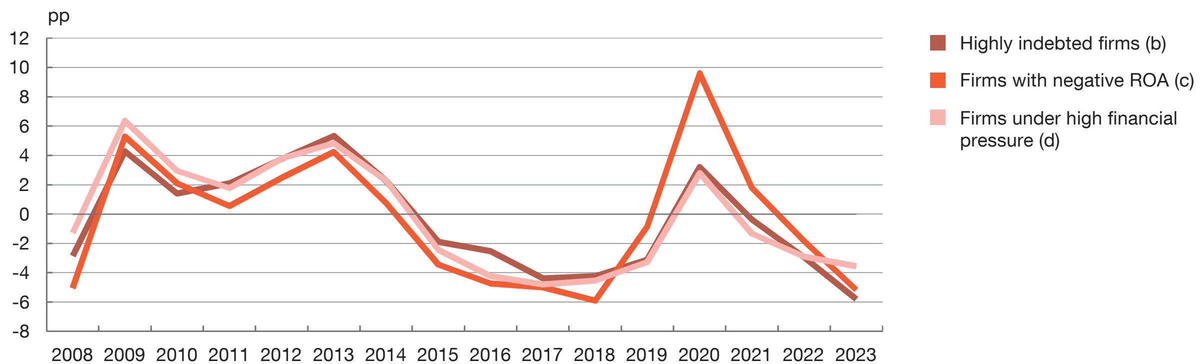
Chart 1.9

Borrowing costs rise for firms, but the CBQ's indices of vulnerability have not increased since 2023 Q2

1.9.a Year-on-year ordinary net profit growth (a). Contribution by components. CBQ



1.9.b Change in percentage of vulnerable firms vs 2008-2023 average, for H1 each year. CBQ



SOURCE: Banco de España.

a The ordinary net profit is defined as (gross operating profit + net financial revenue - net depreciation and amortisation, imparirment and operating provisions.)
b Highly-indebted firms are those with a ratio of net financial debt / (gross operating profit + financial revenue) higher than 10, or with positive net financial debt and zero or negative profits.
c Firms with negative ROA are defined as those whose (ordinary net profit + financial costs) / assets net of non-interest bearing liabilities ratio is less than zero.
d A firm is considered to be under high financial pressure when the ratio of (gross operating profit + financial revenue) to financial costs is below one.

1.3 Non-financial sectors

1.3.1 Non-financial corporations and households

Non-financial corporations

Non-financial corporations (NFCs) face rising financial costs as interest rate rises are passed through to borrowing costs. The average interest rate of the outstanding stock of loans to NFCs stood at 4% in August 2023, 235 bp above the

figure seen at end-2021.[9] In the sample of firms in the Central Balance Sheet Data Office Quarterly Survey (CBQ),[10] the average cost of debt stood at 2.9% in 2023 Q2. Higher financial costs are a growing drain on corporate earnings, as shown in Chart 1.9.a, in spite of firms cutting their debt. The debt ratio of firms in the CBQ, measured in terms of surpluses, has fallen. This is largely the result of strong profits and, to a lesser extent, a reduction in outstanding debt. This ratio stood at 491% in 2023 Q2, similar to, but slightly below, the pre-pandemic figure.

Firms also continue to cope with growing personnel costs stemming from rising wages, along with lower pressure from other production costs, which may not persist into 2023 H2. According to CBQ data, average compensation rose by 6.5% in 2023 H1, nearly 4 pp more than the year before (2.7%). Employment also rose in this period, although slightly more slowly than in 2022. Conversely, other production costs eased (e.g. commodities and energy), such that inputs as a share of total production value dropped in 2023 H1, standing at levels similar to those seen two years earlier. However, according to the latest qualitative data from the Banco de España Business Activity Survey (EBAE, by its Spanish initials),[11] production costs bucked their falling trend, rising again in Q3 in line with the uptick in energy prices. Furthermore, firms have stated that labour availability issues have continued to push wage costs higher.

Corporate earnings appear to have continued growing in 2023 H1, underpinned by growing activity, although they did so more slowly than in the previous year and unevenly across sectors and firm sizes. According to the CBQ, the ordinary net profit for 2023 H1 rose by 17.7%, compared with growth of 101.8% a year earlier. The increase in surpluses holds across sectors, except in the industrial and wholesale and retail trade and hospitality sectors, which saw a decline owing to the poor performance of the oil refining sub-sector and some large wholesale fuel traders. The half-yearly Survey on the Access to Finance of Enterprises in the euro area shows that between October 2022 and March 2023 the proportion of Spanish SMEs reporting a decline in profits outweighed those reporting growth in profits by 20 pp. This gap, however, is smaller than it was six months earlier.

More granular data show that the proportion of CBQ firms that are financially vulnerable has continued to fall.[12] In 2023 H1 there was a decline in the percentage of both CBQ firms with a negative return on assets and those with high levels of debt.[13] Similarly, the percentage of firms under high financial pressure (those whose

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9 These data are sourced from the individual confidential returns that banks submit to the Banco de España.

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

11 Alejandro Fernández Cerezo and Mario Izquierdo. (2023). "Encuesta a las empresas españolas sobre la evolución de su actividad: tercer trimestre de 2023". *Boletín Económico - Banco de España,* 2023/T3, 15.

12 These results are based on the CBQ sample, which, as noted earlier, comprises around 1,000 primarily large firms.

13 Firms with a ratio of net financial debt to (gross operating profit + financial revenue) higher than 10 or those with positive net financial debt and zero or negative earnings.

earnings do not cover their financial costs)[14] also fell among CBQ firms, in spite of the uptick in interest rates. These three indicators of vulnerability based on CBQ data, which are more representative of large firms, stood at historically low levels, between 3 pp and 5 pp below the average for the period 2008-2022, depending on each case (see Chart 1.9.b). The sectoral breakdown shows drops in the percentage of vulnerable firms in all sectors, except that of wholesale and retail trade and hospitality, which appears to be alone in recording moderate rises.

In any case, there may be a slight rebound in levels of vulnerability in the second half of the year. The most recent data from some leading indicators point to an easing of economic activity from Q3 onwards, which would negatively affect ordinary profit. The EBAE shows that the percentage of firms recording a downturn in their economic and financial situation[15] rose to 17% in Q3, 5 pp more than in the previous quarter. Smaller companies saw higher percentages, while, by sector, agriculture, trade and transport stand out, since those areas include a large share of smaller firms. Moreover, Banco de España simulations[16] suggest that the share of total corporate debt held by firms under high financial pressure would increase by between 6.5 pp and 10.3 pp relative to its 2021 level in response to a 450 bp hike in the three-month EURIBOR (in line with what has been seen so far). This pressure could be attenuated or amplified depending on the performance of revenues and other components of business costs.

Households

The strong performance of the labour market and economic activity, along with easing inflation, led to a significant recovery in household income in the first half of the year. According to the National Accounts' sectoral accounts, families' gross disposable income rose by around 8% year-on-year in 2023 Q2 in nominal and four-quarter cumulative terms. This is 1.7% in real terms, meaning that households' purchasing power was slightly above pre-pandemic levels on aggregate.

But the upward path in households' economic situation up to July has come to an end according to the most recent qualitative data. Indicators on households' future financial situation in the European Commission's monthly consumer survey point to a correction. Specifically, in August and September households, especially in the lower income quartiles, were more pessimistic about the future financial situation, partially reversing the previous path of improvement (see Chart 1.10.a).

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14 That is, the ratio of (gross operating profit + financial revenue) to financial costs is below one.

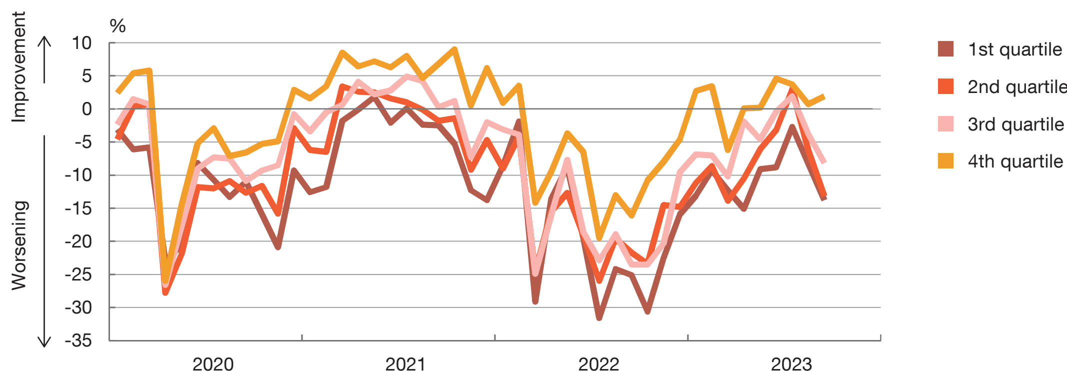
15 A firm is considered to have experienced a downturn in its economic and financial position if, in its response to this survey, it stated that sales and profits had declined while its debt had remained steady or increased.

16 Banco de España (2023). "Chapter 1. Risks linked to the macro-financial environment". In Banco de España, *Financial Stability Report.* Spring 2023.

Chart 1.10

Households' perception of a path of improvement for the financial situation came to an end in July according to the latest data

1.10.a Households' outlook for their economic situation over the next 12 months (a)



SOURCE: European Commission.

a The Consumer Confidence Indicator (European Commission) = percentage of households expecting their economic situation to improve significantly × 1 + percentage expecting their economic situation to improve somewhat × 1/2 - percentage of households expecting their economic situation to worsen somewhat × 1/2 - percentage expecting their economic situation to worsen significantly × 1.

The improvement in families' purchasing power and more moderate growth in consumption allowed the saving ratio to rally in 2023 H1. This rise in saving appears to be broad-based across income brackets, although it is more marked in higher income quartiles, according to the ECB's consumer expectations survey. The same survey also points to an increase since mid-2022 in the percentage of households planning to save in the following year, standing at around 50% at July 2023.

However, rising interest rates have raised financial pressure on households that have a mortgage. The average cost of the outstanding balance of the stock of loans for house purchase stood at 3.4% in August 2023, 234 bp above the figure recorded at end-2021. This increase covers the updating of variable-rate mortgages (which in June represented around 68%[17] of all outstanding mortgages) as well as the higher rates on new mortgages agreed in the previous year and a half.

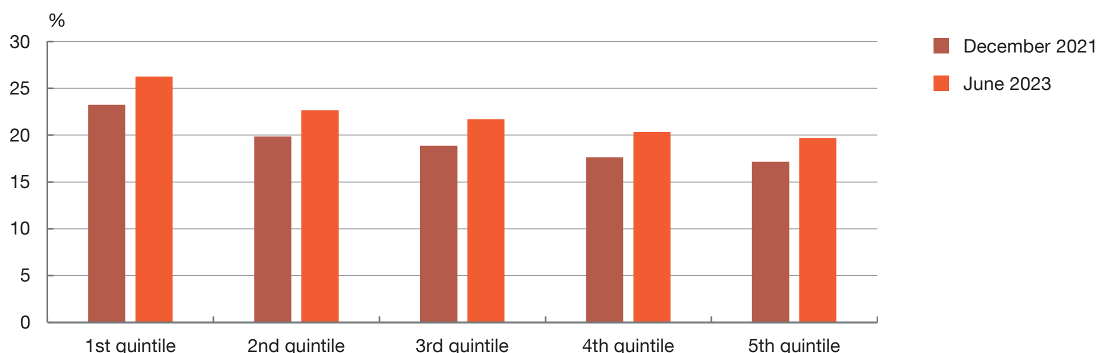
The debt burden of mortgage-indebted households[18] increased across all income brackets, although in a limited fashion, cushioned by rising nominal

17 These data are sourced from the individual confidential returns the banks submit to the Banco de España and includes all variable-rate mortgages, even if the interest rate is fixed for a certain time.

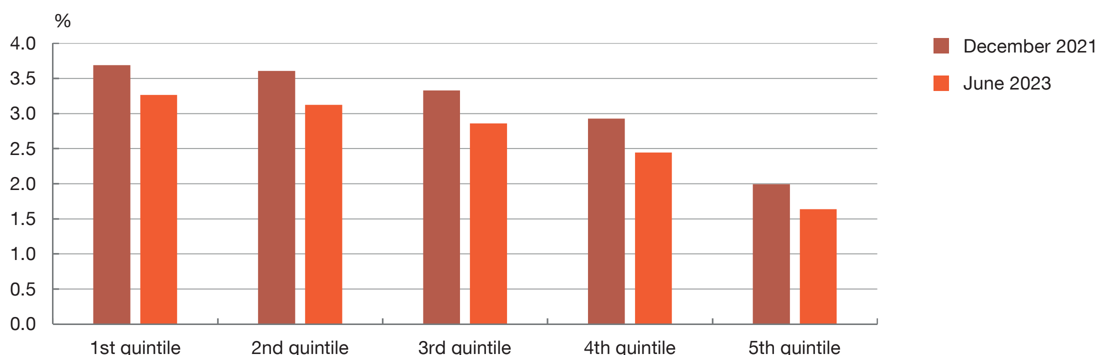
18 In the two lowest income quartiles, where households are more vulnerable to inflation and interest-rate rises, the percentage of households that have a variable-rate mortgage is lower, around 10% and 20% for the lowest and second-lowest quintiles, respectively. This figure rises to 45% among the highest income brackets. The smaller share of variable-rate mortgages held by those in lower income brackets essentially shows there are fewer indebted households and not necessarily a lower share of variable-rate loans to borrowers. See "Chapter 3. The current episode of price pressures in the euro area, the monetary policy response and its effects". In Banco de España, *Annual Report 2022.*

Chart 1.11
The financial burden of mortgages grew across all income quintiles, although non-performing mortgages continued to fall

1.11.a Loan service-to-income ratio of the mortgage portfolio at each date by income quintile (a)



1.11.b NPL ratio of the mortgage portfolio at each date by income quintile (b)



SOURCE: INE and Banco de España.

a The chart shows the loan service-to-income (LSTI) ratio of outstanding mortgages for two dates and in each income quintile. The LSTI ratio shows the relationship between the annual mortgage servicing cost and household income (proxied using average gross annual household income in the same postcode). The values shown correspond to the average LSTI ratio in each quintile, weighted by the oustanding loan amount. Data for household income broken down by postcode are not available for recent years. Therefore, the present values are calculated taking the latest income data and based on changes in the average net income per household in the INE's Living Conditions Survey.

b The income quintiles are calculated using the same method as for the chart above on the LSTI. The NPL ratio for each quintile is defined as the ratio of the outstanding balance of non-performing loans at each date to total mortgages to households in that quintile.

incomes. Estimations of the debt burden in Chart 1.11.a show a rise in the loan service-to-income ratio of around 2.8 pp between end-2021 and mid-2023 for mortgage-indebted households. This increase was slightly higher for indebted households in lower income quintiles. In any case, the non-performing mortgage loan ratio dropped across all income brackets (see Chart 1.11.b).

The transmission of monetary policy to households' financial costs is still incomplete. The increase in the average cost of mortgages represents around half of the rise in the 12-month EURIBOR in that same period, which suggests that the transmission to the average cost of the outstanding balance is not yet complete, given that nearly 70% of outstanding mortgages by volume are variable rate. It is estimated that slightly less than one-third of variable-rate mortgages will undergo a

100 bp revision in their interest rate between June 2023 and June 2024. In addition, according to Banco de España simulations,[19] the percentage of indebted households with a high net interest burden[20] would face upward pressure of 4.2 pp, to 14.6%, given a rise in the 12-month EURIBOR of 500 bp (slightly above that seen to date). Families between the 20th and 60th income percentiles would be those most affected by this shock. This pressure could be attenuated or amplified depending on changes in income and consumer prices. Box 1.2 analyses the use of the codes of good practice by mortgage lenders in 2023 H1.

1.3.2 General government in Spain

Following the deterioration in 2022 Q4, Spain's general government deficit appears to have fallen slightly in 2023 H1. The cumulative outstanding balance for the previous twelve months stood at 4.4% of GDP in June 2023 (latest available figure), 0.3 pp below that of December 2022.

The upward revision of GDP figures since 2020 has led to a drop in the government debt ratio. As a result of this statistical revision, the debt-to-GDP ratio fell by 1.9 pp in June 2023, from 113.1% to 111.2%.

The Banco de España's latest projections, published in September and automatically adjusted to the new 2022 GDP level, still place the general government deficit at more than 3% of GDP and the debt-to-GDP ratio above 100% over the projection horizon, up to 2025 (see Chart 1.12.a).[21] These projections continue to point to a significant structural imbalance in Spain's public finances.

Absent new measures, government debt will remain high. As shown in Chart 1.12.b, the fall in the debt ratio from its peak in 2020 is solely due to robust growth in nominal GDP, since the absolute value of the debt continues to grow. According to current forecasts, this ratio will be around 16% higher in 2023 than its pre-pandemic level. In the next few years, the moderation in nominal GDP growth, the persistence of a slight primary deficit and rising debt servicing payments will together contribute to offsetting the downward trend in government debt.

These levels of debt constitute a source of vulnerability for the Spanish economy, although there are some mitigating elements. This is due to both the

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19 Banco de España. (2023). "Chapter 1. Risks linked to the macro-financial environment". In Banco de España, *Financial Stability Report.* Spring 2023.

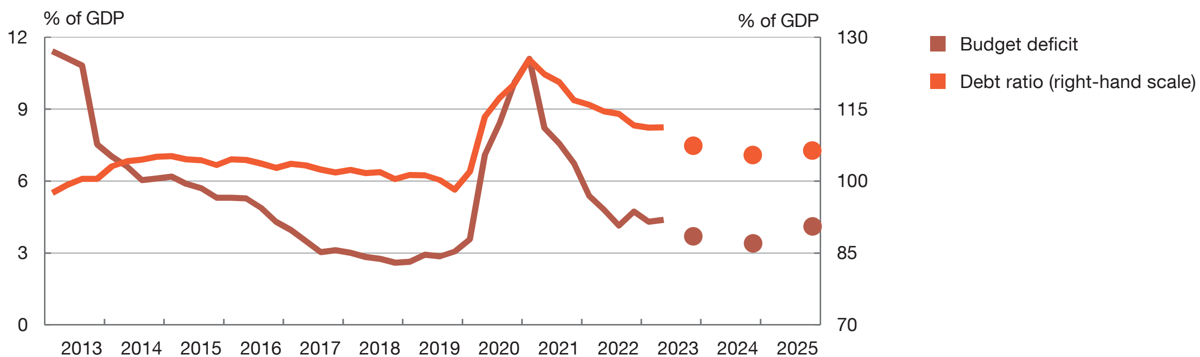
20 The net financial burden is considered high when it exceeds 40% of household income.

21 Banco de España. (2023). "Macroeconomic projections for the Spanish economy (2023-2025)". In "Quarterly report and macroeconomic projections for the Spanish economy (2023-2025). September 2023". In *Economic Bulletin - Banco de España,* 2023/Q3.

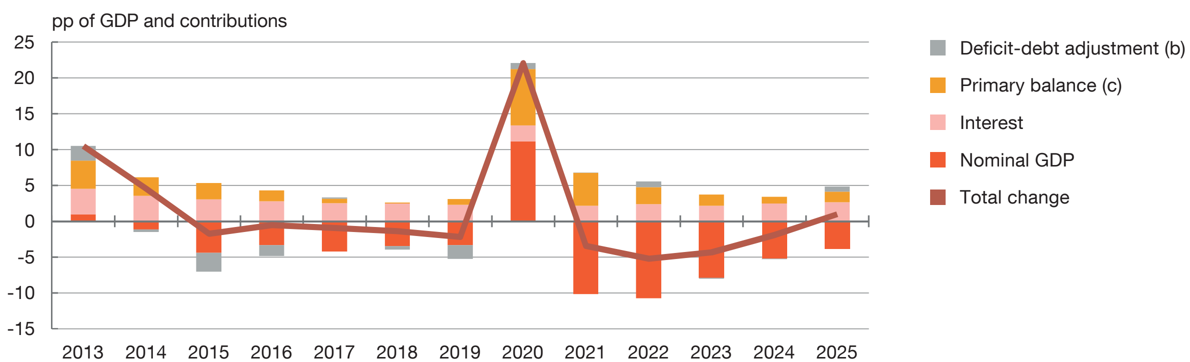
Chart 1.12

Spain's public finances continue to be a source of vulnerability

1.12.a General government's financial position (a)



1.12.b Drivers of change in the debt ratio



SOURCES: IGAE and Banco de España.

a The circles denote the Banco de España's macroeconomic projections published on 19 September 2023, adjusted, in the case of debt, to the new GDP level published by INE on 18 September.

b The deficit-debt adjustment shows changes in government debt – calculated in accordance with the excessive deficit procedure (EDP) – which are not the result of the primary balance plus interest. Specifically, this component includes net asset purchases (which must be funded), net liabilities taken on that are not included in EDP debt (such as commercial lending), valuation adjustments and reclassifications.

c The primary balance excludes interest costs.

lack of room for manoeuvre in response to possible adverse shocks in the future and greater sensitivity to changes in market rates triggered by such shocks. Conversely, the relatively distant maturity of the outstanding debt and the mechanisms in place at European level to limit unjustified tightening on sovereign debt markets (such as the Transmission Protection Instrument) act as buffer elements against such risks.

In the short and medium term, the tightening of monetary policy will continue to progressively nudge debt interest spending higher. Since spring 2022, interest rates on public sector issuances have continued to grow in line with expectations. At the same time, significant tightening of sovereign debt market has not materialised – the ten-year risk premium on Spanish debt over German debt has remained at

around 100 bp. In this context, the interest payment burden is still expected to rise gradually, from 2.2% of GDP (forecast for 2023) to 2.6% (in 2025), with further growth to come in later years.

Over a longer time frame, the obligations stemming from population ageing, climate change-related challenges and digitalisation, along with higher defence spending (which the current, more unstable, geopolitical situation may demand), will also squeeze public finances. Against that backdrop, it is important to make the best possible use of available resources and bolster the Spanish economy's potential growth, both via government programmes with a strong spillover effect on private initiatives as well as structural reforms, for which the efficient use of NGEU resources is crucial.

In any case, removing public finances as a source of vulnerability for the Spanish economy may only be achieved by a sustained process of fiscal consolidation, which must be undertaken as soon as possible. The current cyclical position of the Spanish economy and the expansionary effects of the NGEU programme warrant the launching of this process and the return to EU-wide fiscal rules in 2024, following their temporary suspension from 2020 to 2023, should mark its beginning.

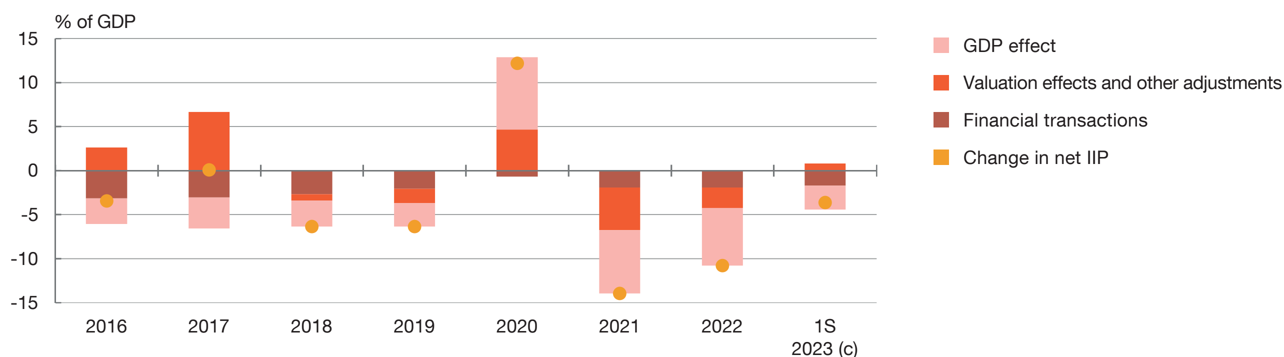
1.3.3 Financial flows vis-à-vis the rest of the world and the international investment position

In 2023 H1, capital inflows to Spain were very high, owing to the replacement of maturing Eurosystem refinancing operations. Inflows (€127.3 billion, the highest half-yearly amount since before the global financial crisis) comfortably exceeded net purchases of foreign assets by resident agents (€64.9 billion). The main destination of international inflows were deposits (€80.6 billion) and especially short-term deposits (61.7 billion), followed by long-term general government debt securities (€36.2 billion). These robust inflows of deposits are linked to replacement of the ECB's targeted longer-term refinancing operations (TLTRO-III) as they matured. Although banks have funded the large majority of these maturities, cutting excess Eurosystem liquidity, a portion was financed via market operations, in particular by means of repurchase agreements and senior debt issuances.

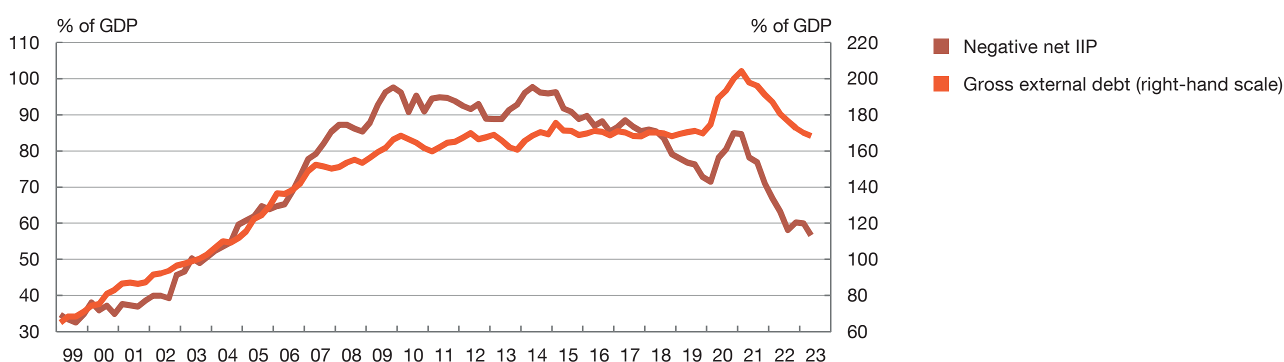
Spain's negative net international investment position (IIP) continued on its corrective trajectory in 2023 H1. The IIP fell to 56.6% of GDP in June, its lowest level since 2004. However, this level is still around 20 pp above the threshold of 35% of GDP stipulated in the European Commission's macroeconomic imbalance procedure framework. The H1 fall (of 3.6 pp) can largely be explained by growth in nominal GDP (by 2.7 pp) (see Chart 1.13.a).

Chart 1.13
GDP growth allows the correction of external imbalance ratios to continue

1.13.a Determinants of the change in negative net IIP (a)



1.13.b Negative net IIP and gross external debt (a) (b)



SOURCE: Banco de España.

a Negative net IIP is the difference between the value of national liabilities to the rest of the world and resident sectors' foreign assets.
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.

Spain's gross external debt as a percentage of GDP continued to decline in 2023 H1, to stand at 168.3%. As a result, the growth in nominal GDP meant that this ratio decreased by 4.4 pp relative to end-2022 (see Chart 1.13.b). Conversely, the absolute value of foreign debts continued to rise, reaching an all-time high of €2,373 billion. Although certain mitigating elements exist, such as the makeup of liabilities in terms of their maturity, agreed interest rate, issuer and currency,[22] the volume of foreign debt is a source of vulnerability for the Spanish economy, especially in a high interest rate environment.

22 There is a predominance of debt issued as long-term debt and by the public sector, denominated in euro and mainly at a fixed rate.