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EURO AREA ECONOMIC OUTLOOK AND THE ECB'S MONETARY POLICY

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THE CURRENT ANALYTICAL FRAMEWORK ON WHICH THE ECB'S DECISIONS ARE BASED

- The ECB's Governing Council (GC) interest rates decisions follow a **data-dependent approach**. In particular, they are based on its assessment of:

The inflation outlook in light of the incoming economic and financial data

The dynamics of underlying inflation

The strength of monetary policy transmission

- The October decision of keeping **the three ECB interest rates unchanged** was based on the assesstment of these three elements.

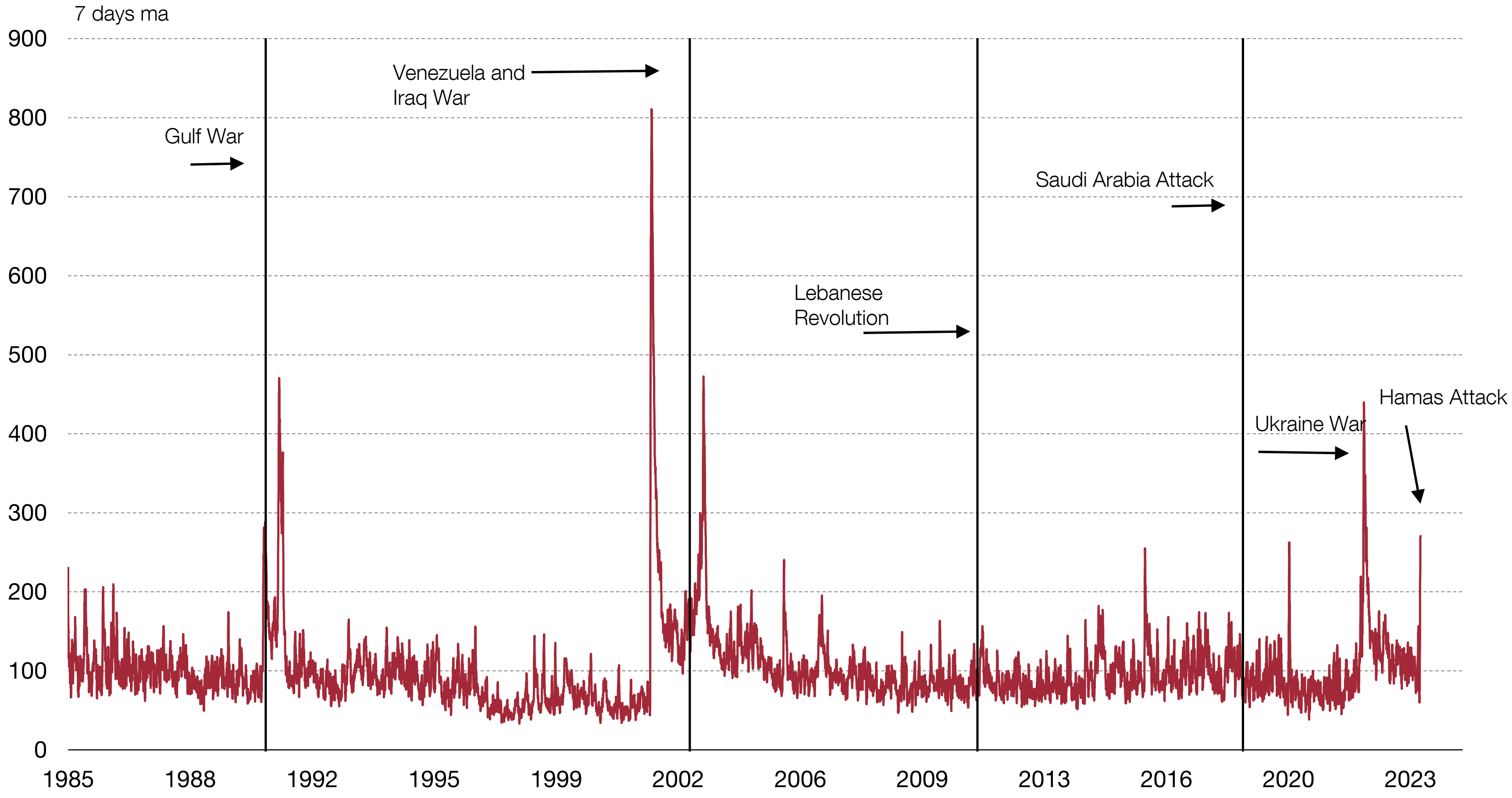
  - The decision was taken after ten consecutive hikes, which implied a cumulative increase of 450 bps and took the deposit facility rate up to 4%, and in a context in which the speed of reduction of the Eurosystem's balance has been extraordinary.

ROADMAP

1. **The economic growth outlook**
2. The inflation outlook, including the dynamics of underlying inflation
3. The strength of monetary policy transmission
4. What can we expect going forward from the ECB's monetary policy?

A NEW GEOPOLITICAL RISK HAS MATERIALIZED RECENTLY IN THE MIDDLE EAST, WITH A RELATIVELY LIMITED IMPACT ON GLOBAL RISK TO DATE

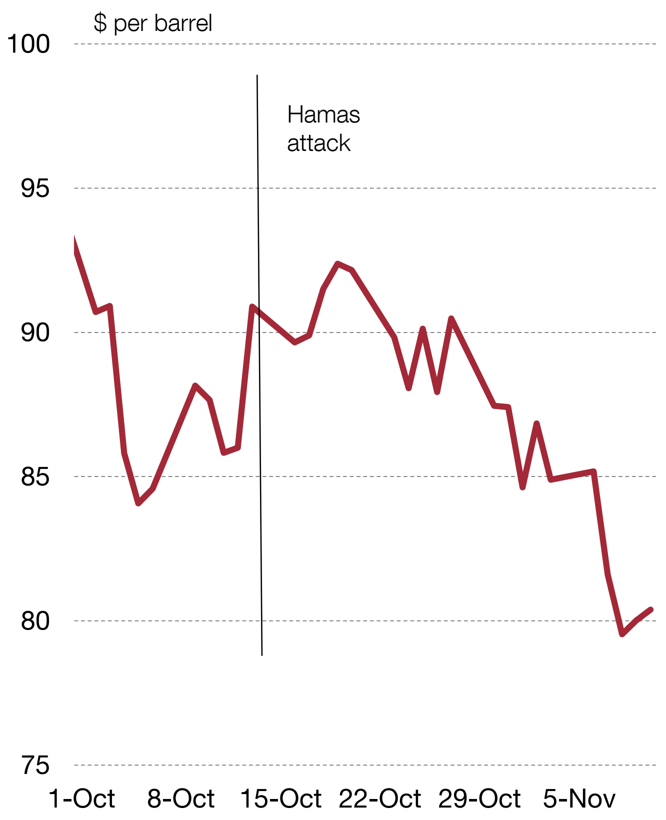
Geopolitical risk index



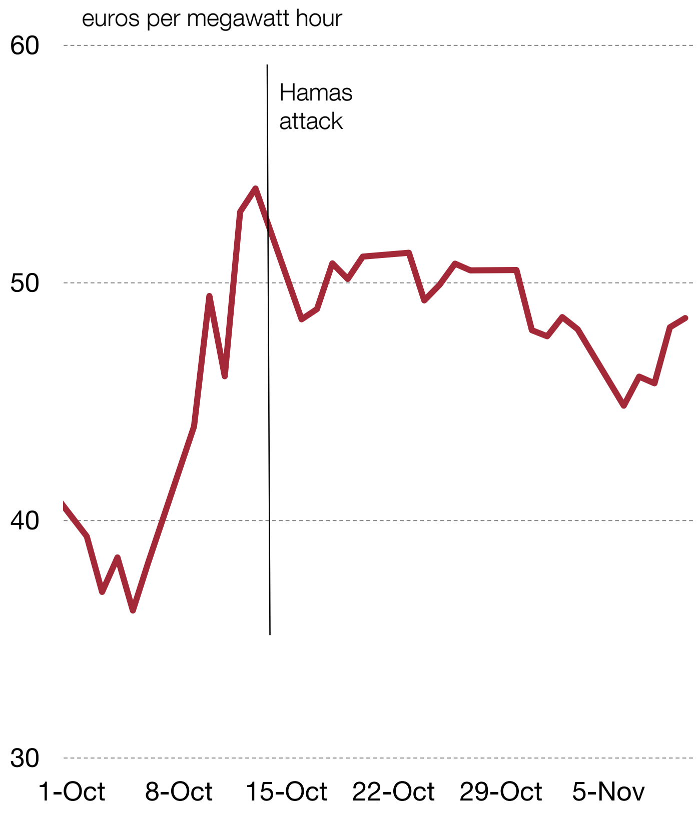
Sources: Own elaboration with data from Iacoviello and Caldara (2022) and Refinitiv. Last observation: 6th November.

SO FAR THIS SHOCK HAS AFFECTED ONLY SLIGHTLY BOTH ENERGY MARKETS AS WELL AS UNCERTAINTY

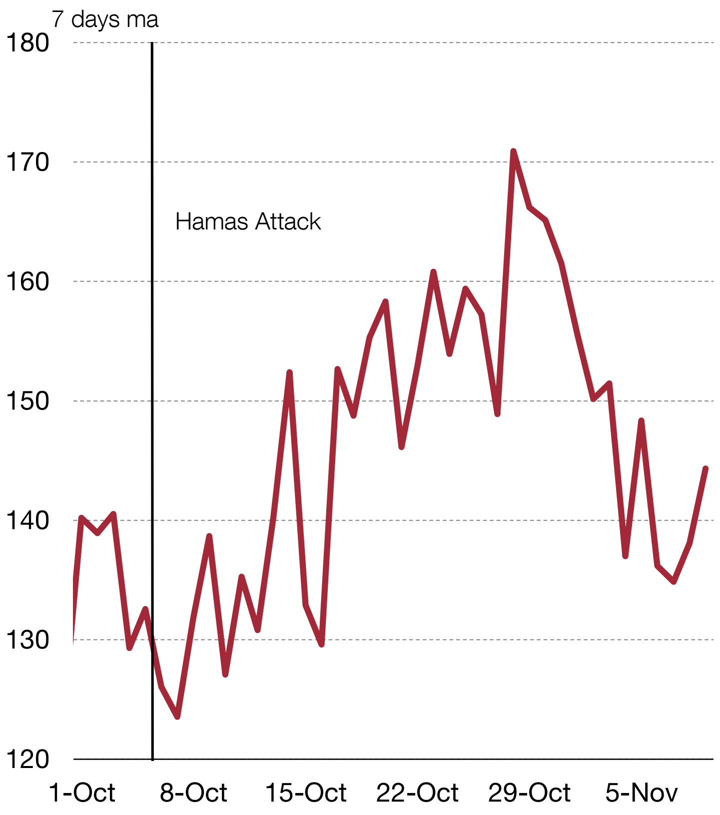
Oil price



Natural gas Price (TTF)



EPU Spain

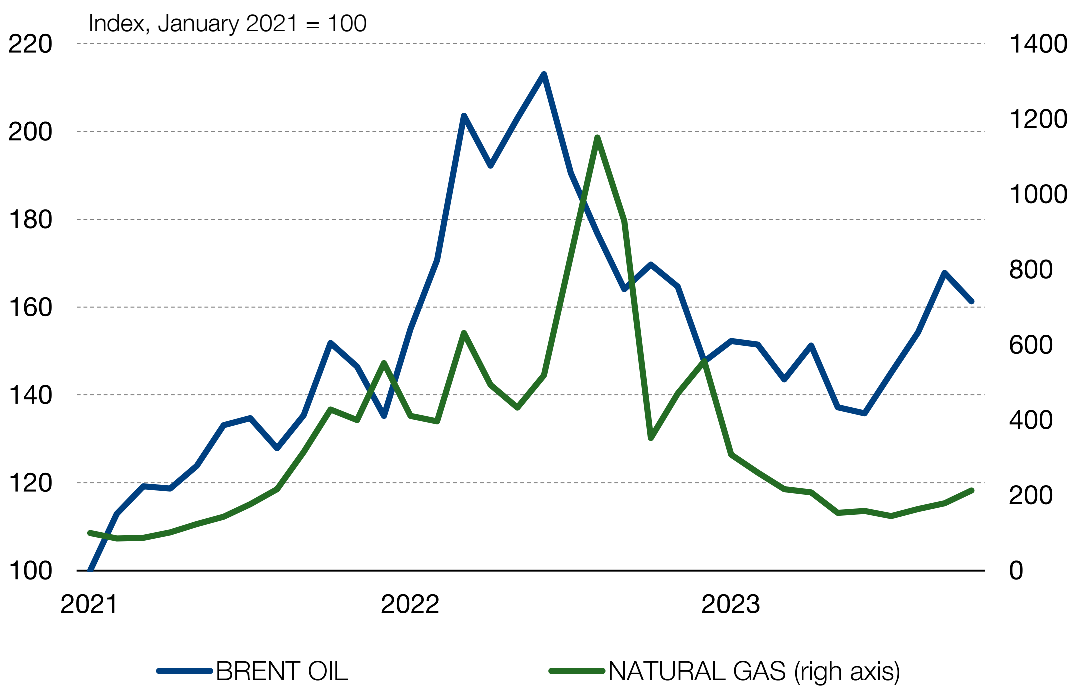


Sources: Refinitiv and Factiva Dow Jones. Last observation: 10th November.

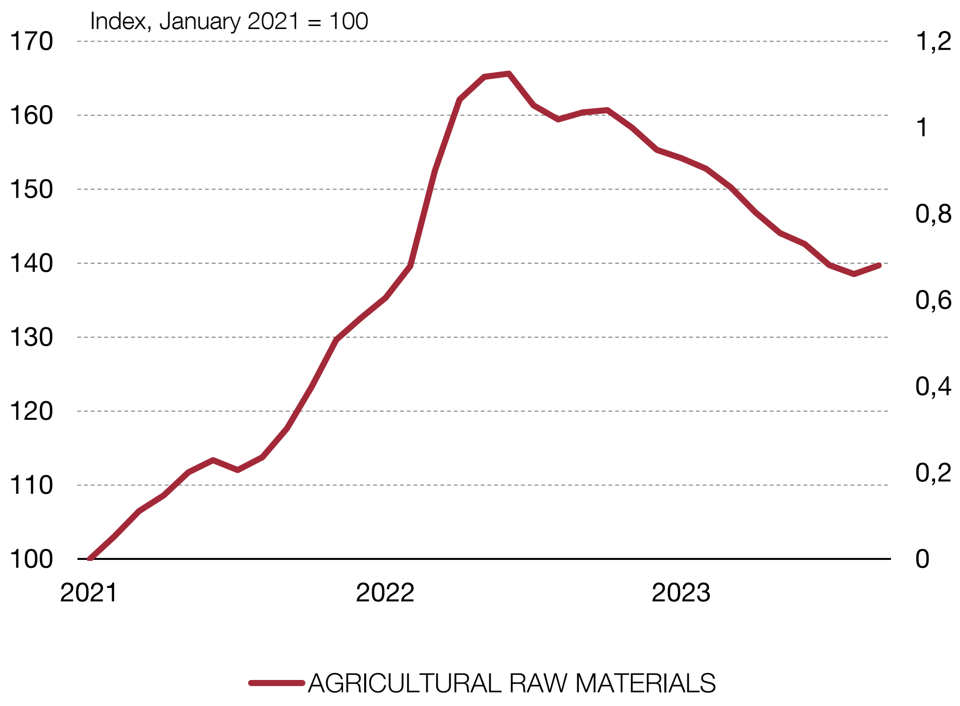
OIL PRICE HAS RISEN SINCE JULY, WHILE FOOD COMMODITY PRICE CONTINUES TO MODERATE

Commodity prices

Oil and gas



Food



Sources: Bank of Spain and Eurosystem. Last observation: October.

INCREASE OF LONG-TERM INTEREST RATES THAT HAVE RECEDED RECENTLY, AND DEPRECIATION OF THE EURO

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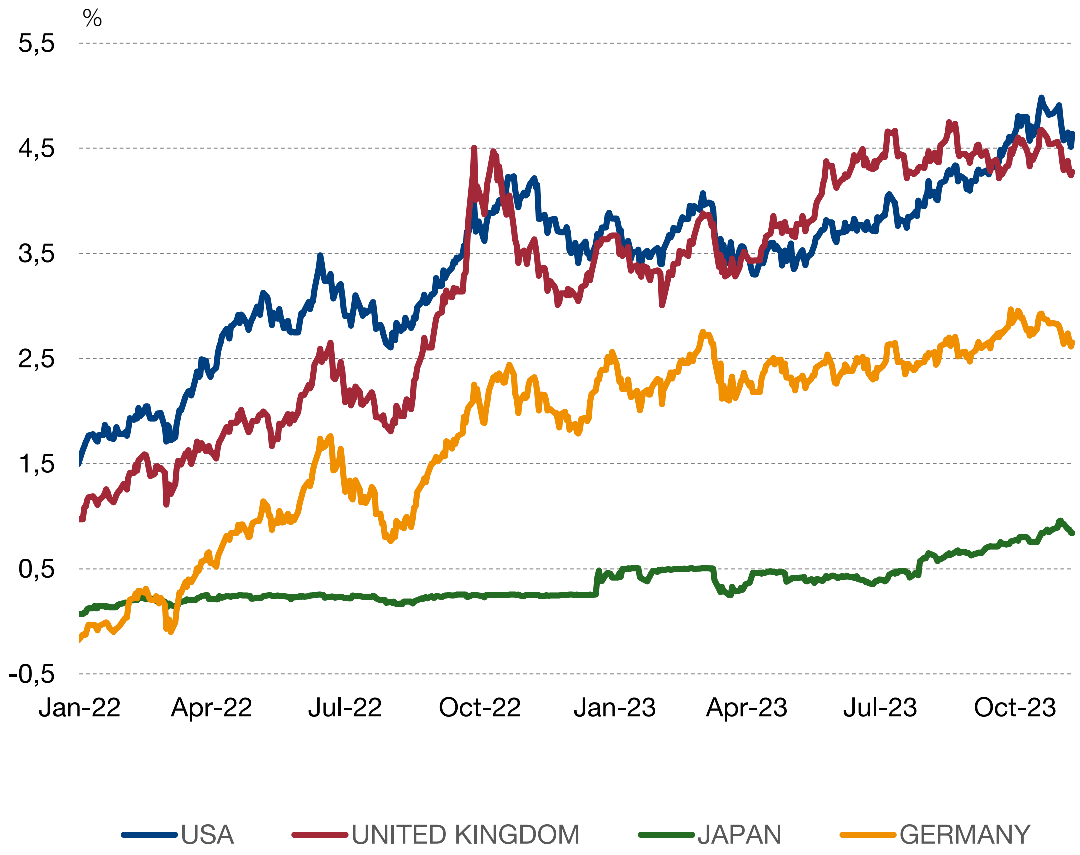
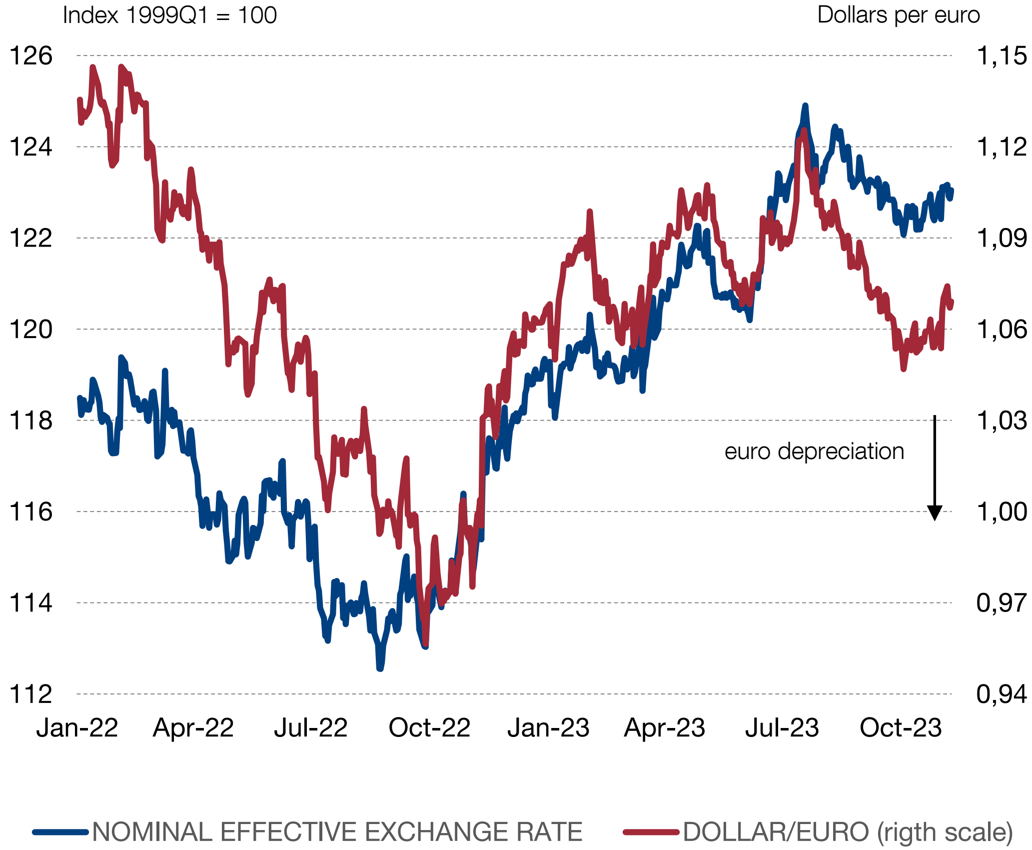
10-year bond interest rates

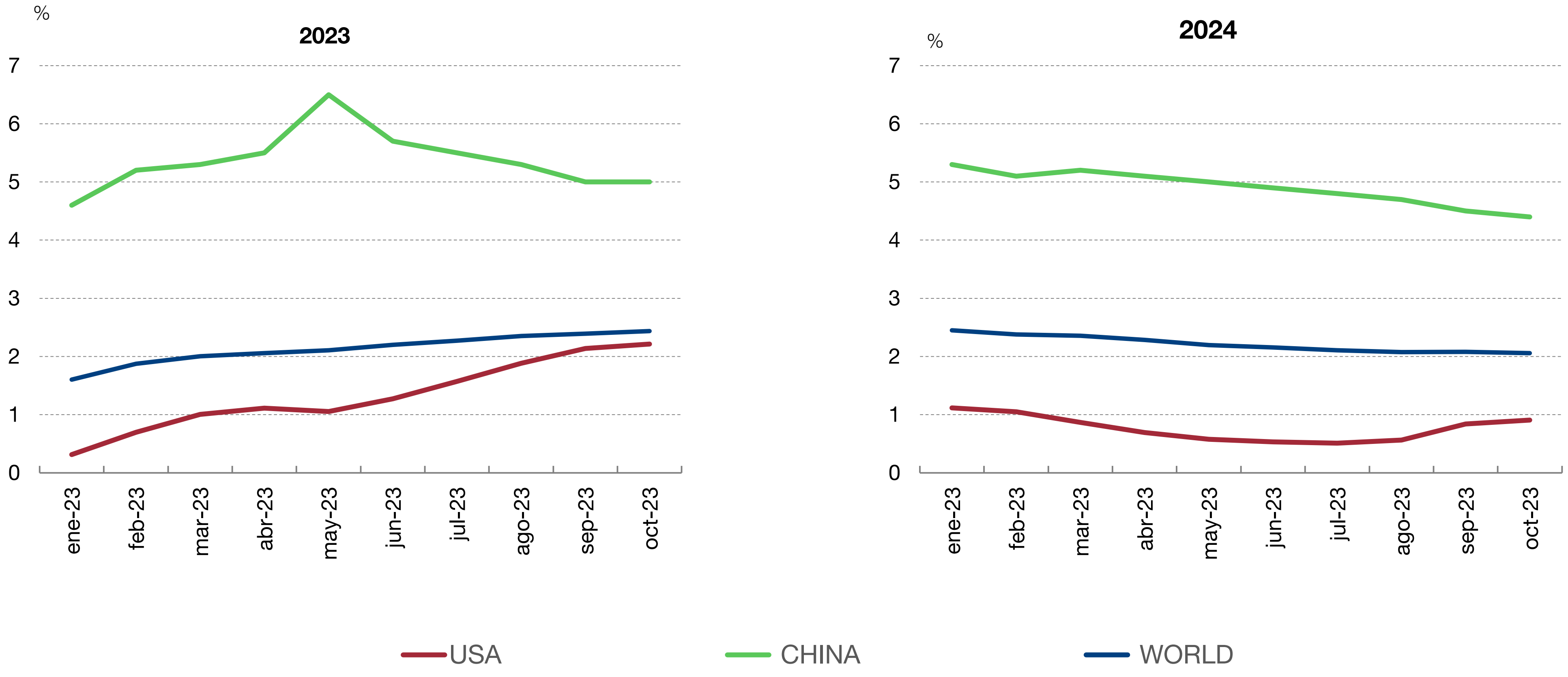


Euro exchange rates



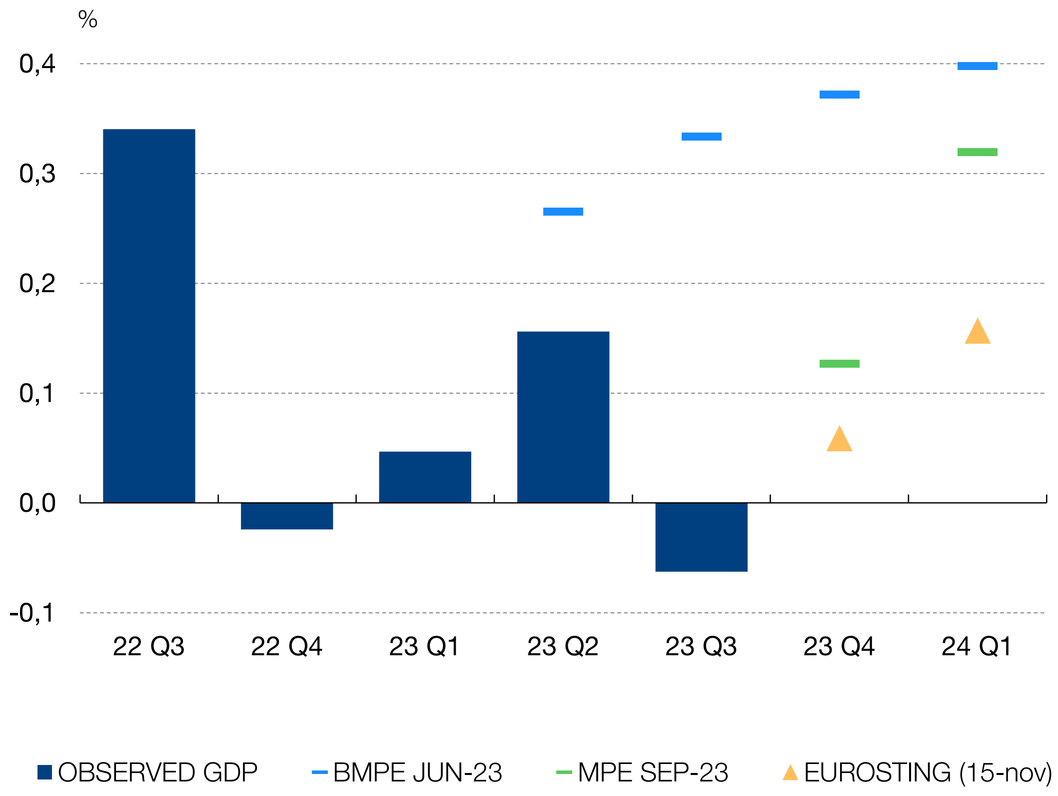
SOURCES: Refinitiv Datastream, Bank of Spain and Eurosystem. Last observations: 10/11/2023 (yields) and 09/11/2023 (exchange rate).

Consensus: GDP growth forecasts

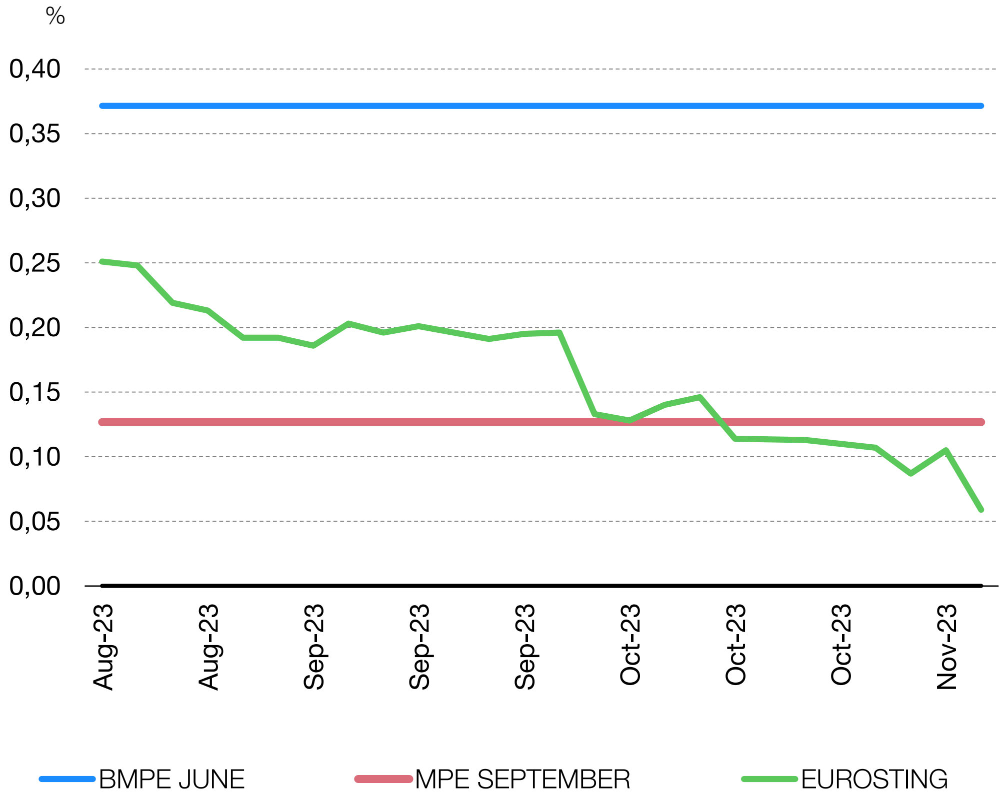


EMU GDP quarter-on-quarter growth forecasts

Short-term models



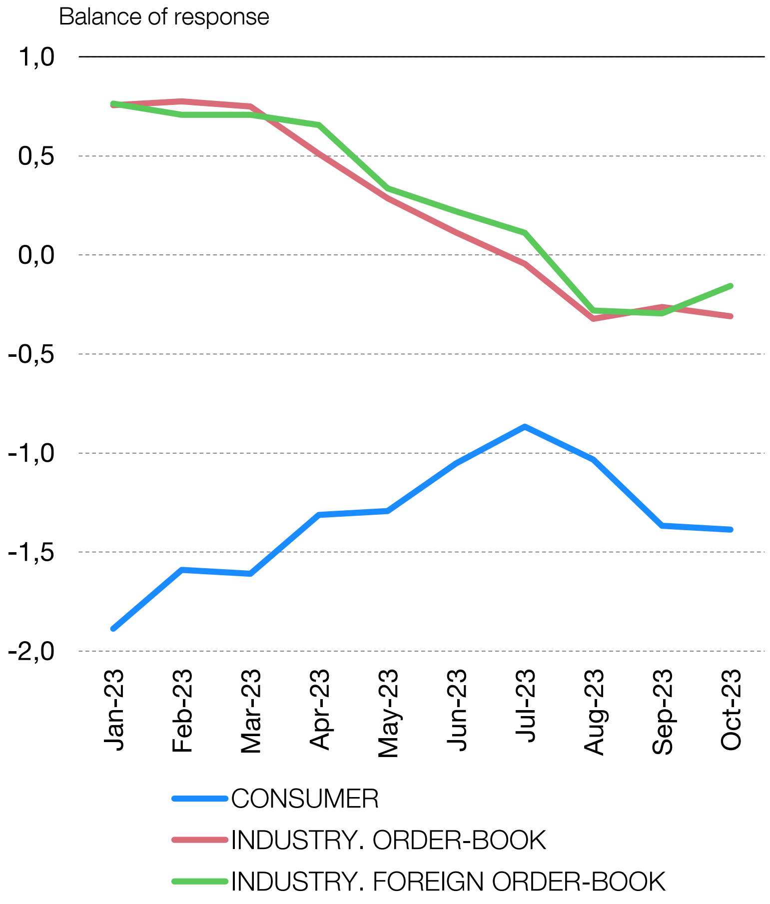
Eurosting. Fourth quarter



Sources: Bank of Spain and Eurosystem.

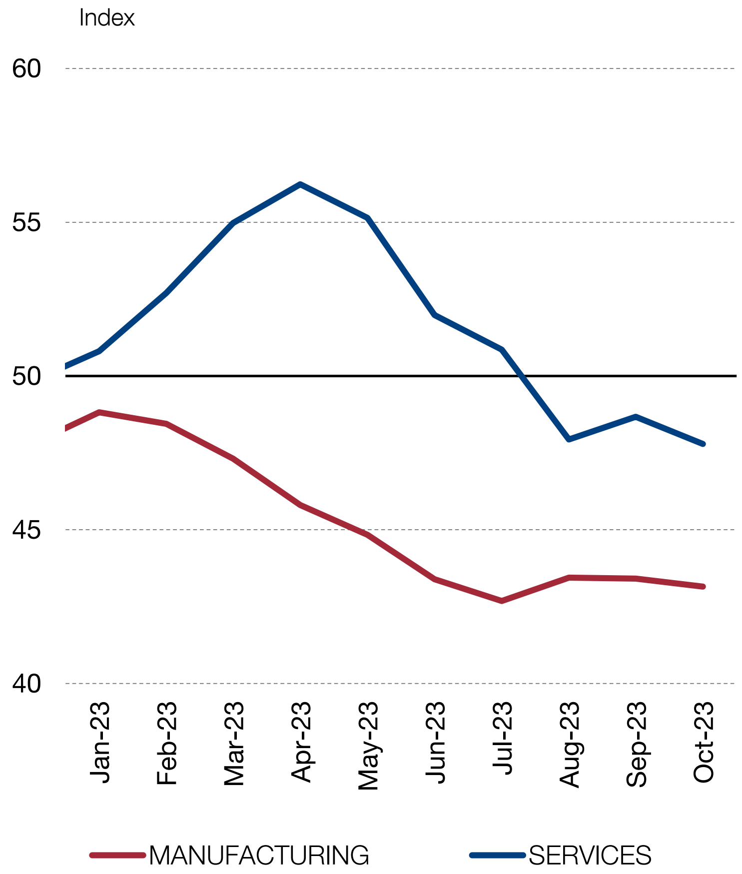
GROWTH MODERATION IS GENERALIZED ACROSS DEMAND AND SUPPLY COMPONENTS, AS WELL AS ACROSS COUNTRIES

EMU: CE confidence indicators (a)

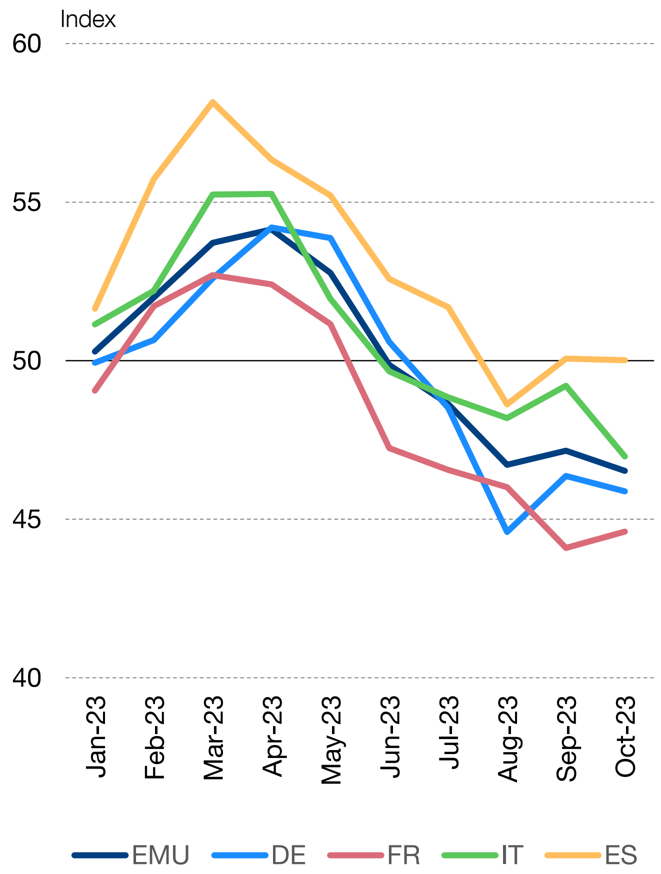


(a): Normalized series.

EMU: Sectoral PMI



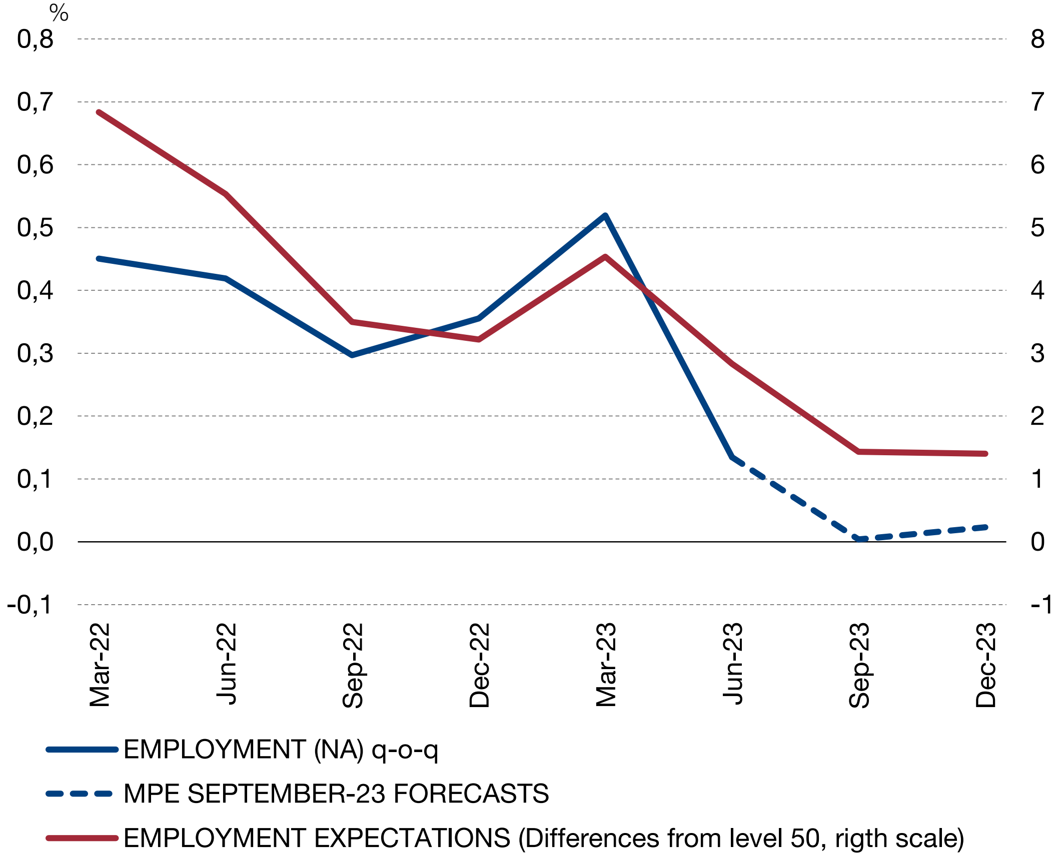
Composite PMI by countries



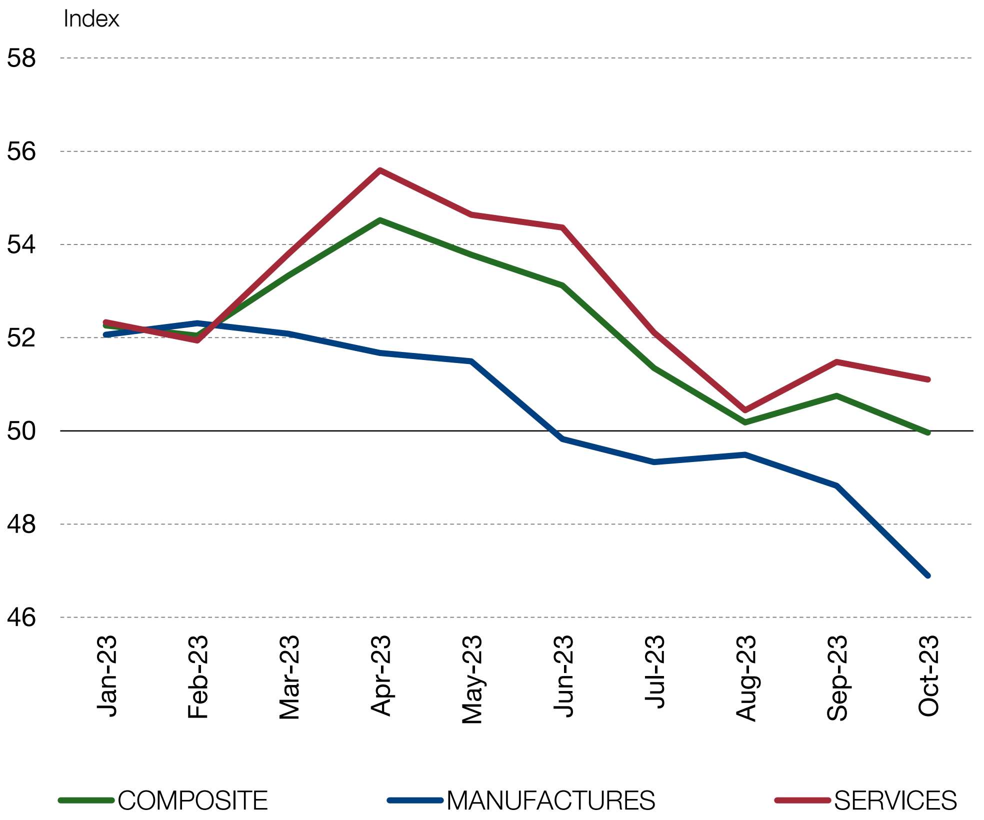
Sources: European Comission and S&P Global. Last observation: October.

EMU employment indicators

Employment (NA) and employment expectations



Employment PMI



Sources: Eurostat, European Comission and S&P Global. Last observation: employment National Accounts: 2023Q2; employment PMI and employment expectations: October.

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ROADMAP

1. The economic growth outlook
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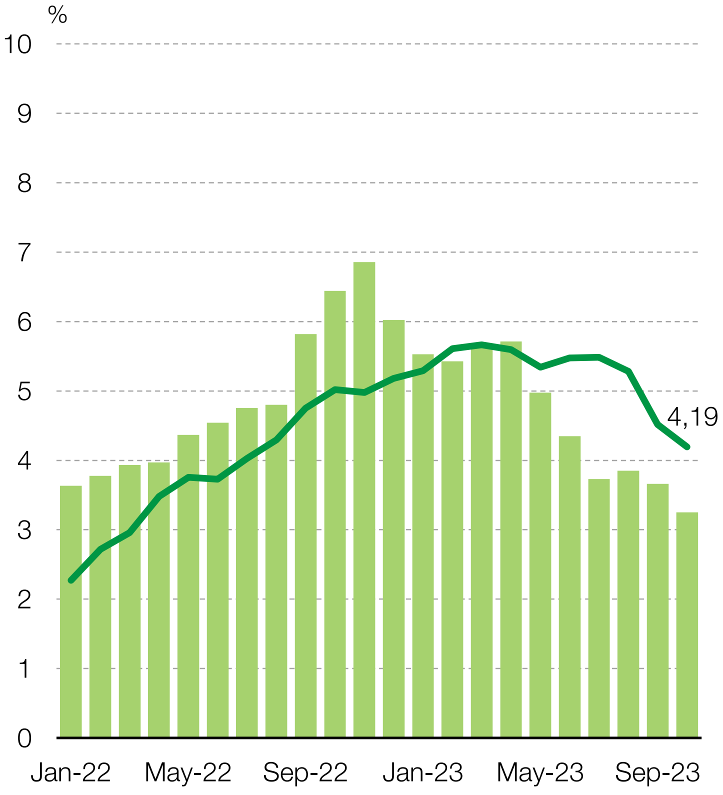
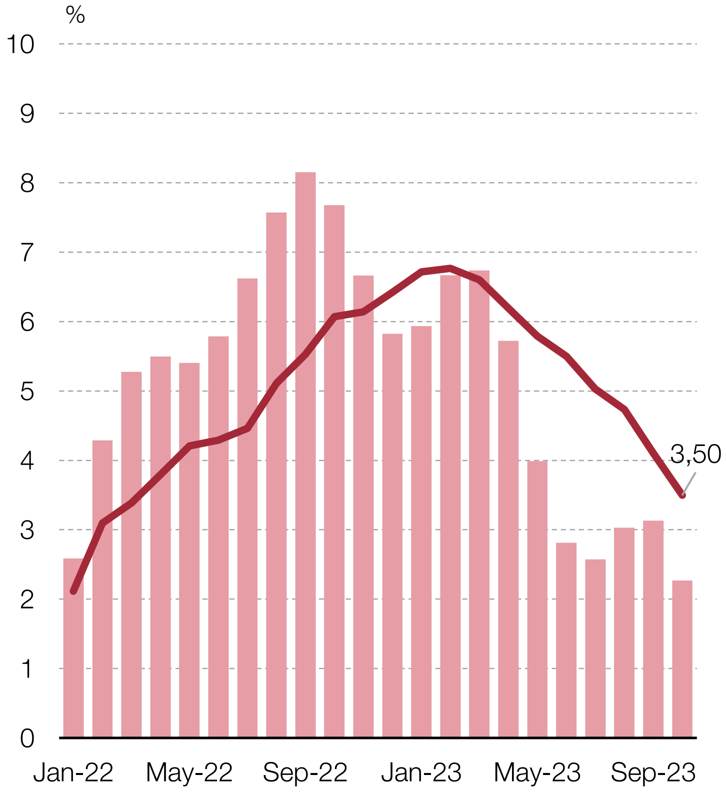
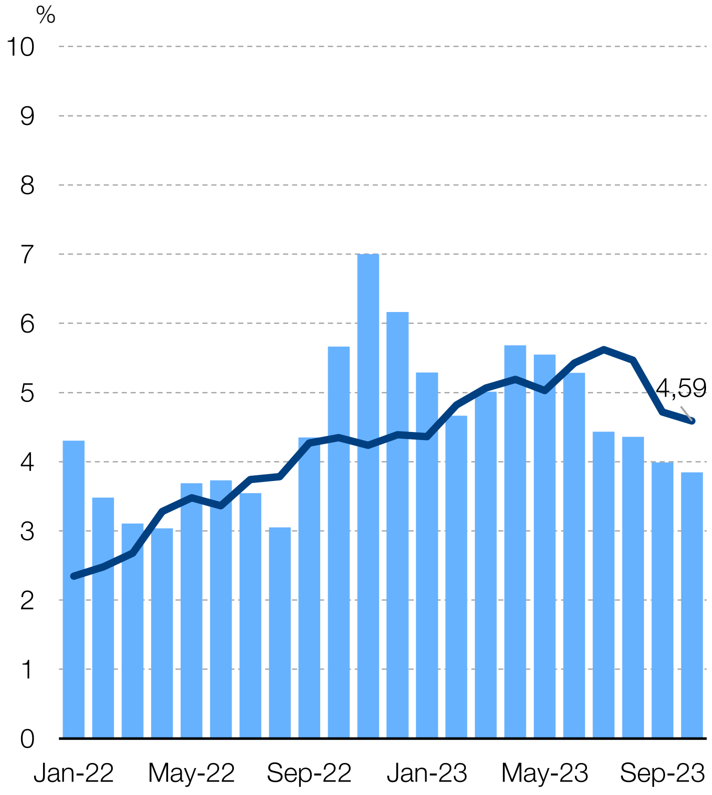
HICP. Energy and food excluded



HICP. Non-energy industrial goods



HICP. Services



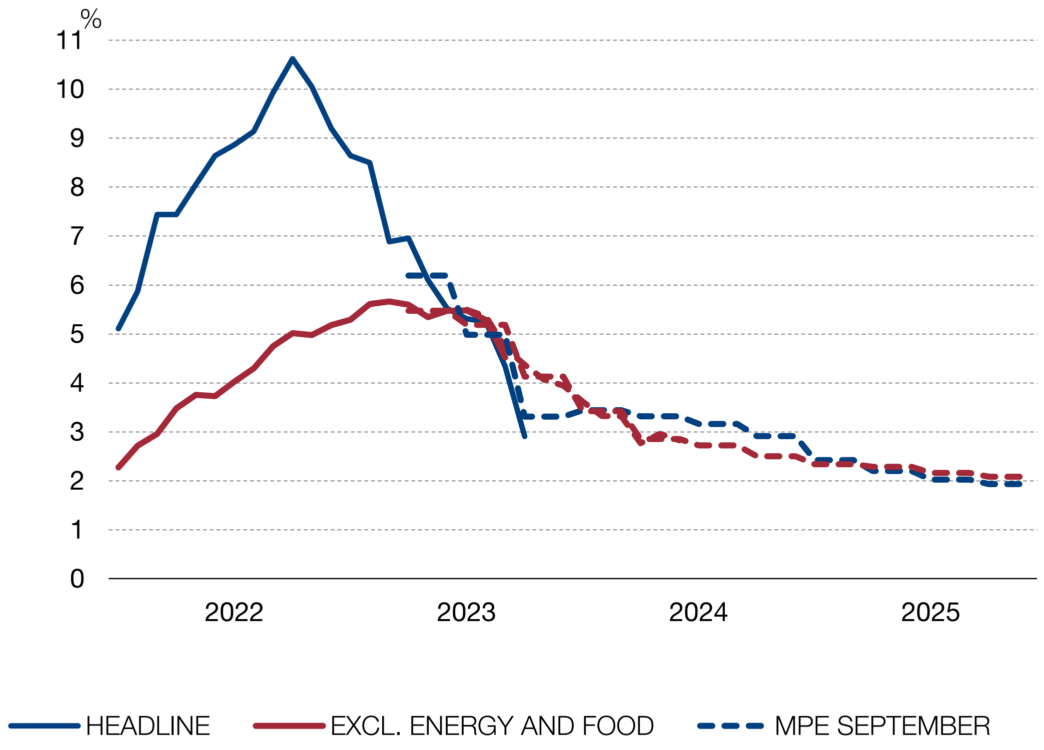
MOMENTUM (a) YEAR-ON-YEAR (T1,12)

(a): Momentum is defined as the rate of change of the three-month average HICP over the average of the immediately preceding three months, in annualized terms.

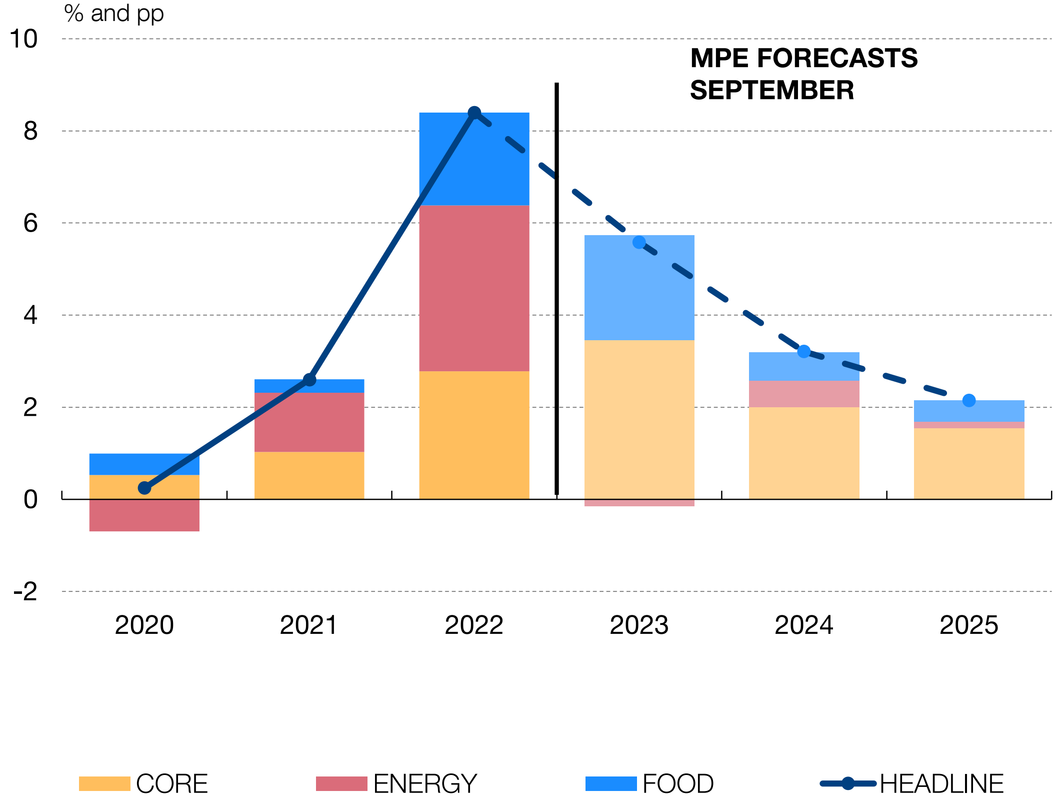
Sources: Eurostat and ECB. Last observation: October.

…WHICH LET US GAIN CONFIDENCE ABOUT THE EXPECTED REDUCTION IN INFLATION, BASED BOTH ON THE MOST VOLATILE COMPONENTS (FOOD AND ENERGY), AS WELL AS ON CORE INFLATION

EMU. Inflation



Inflation and contribution of components

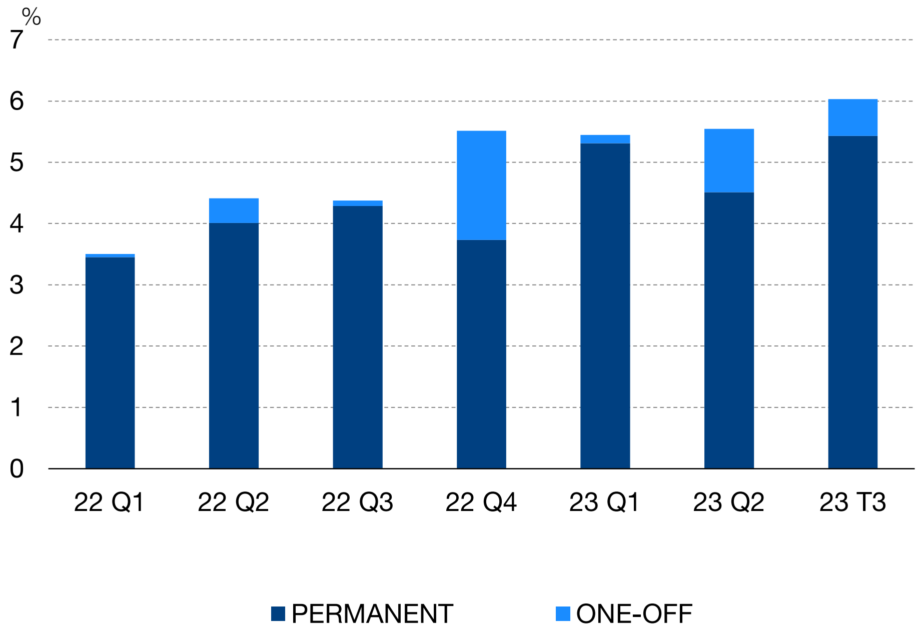


Sources: Eurostat and Eurosystem. Last observation: October.

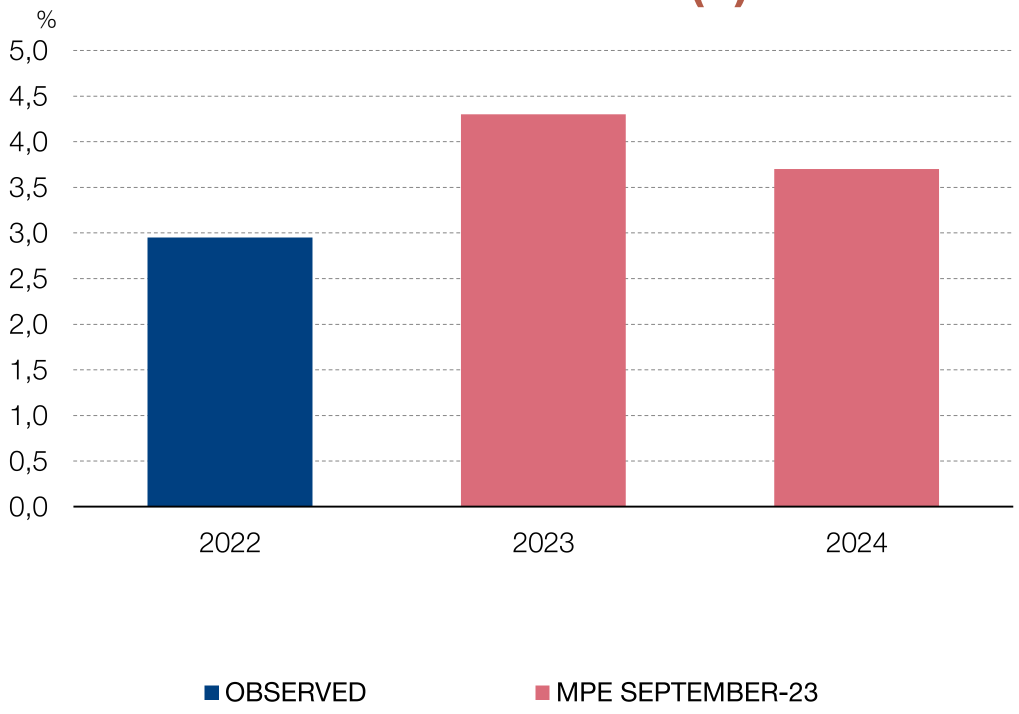
SALARY PRESSURES REMAIN HIGH BUT IN LINE WITH EXPECTATIONS

Negotiated wages (year-on-year growth)

EMU. New signature agreements (a)



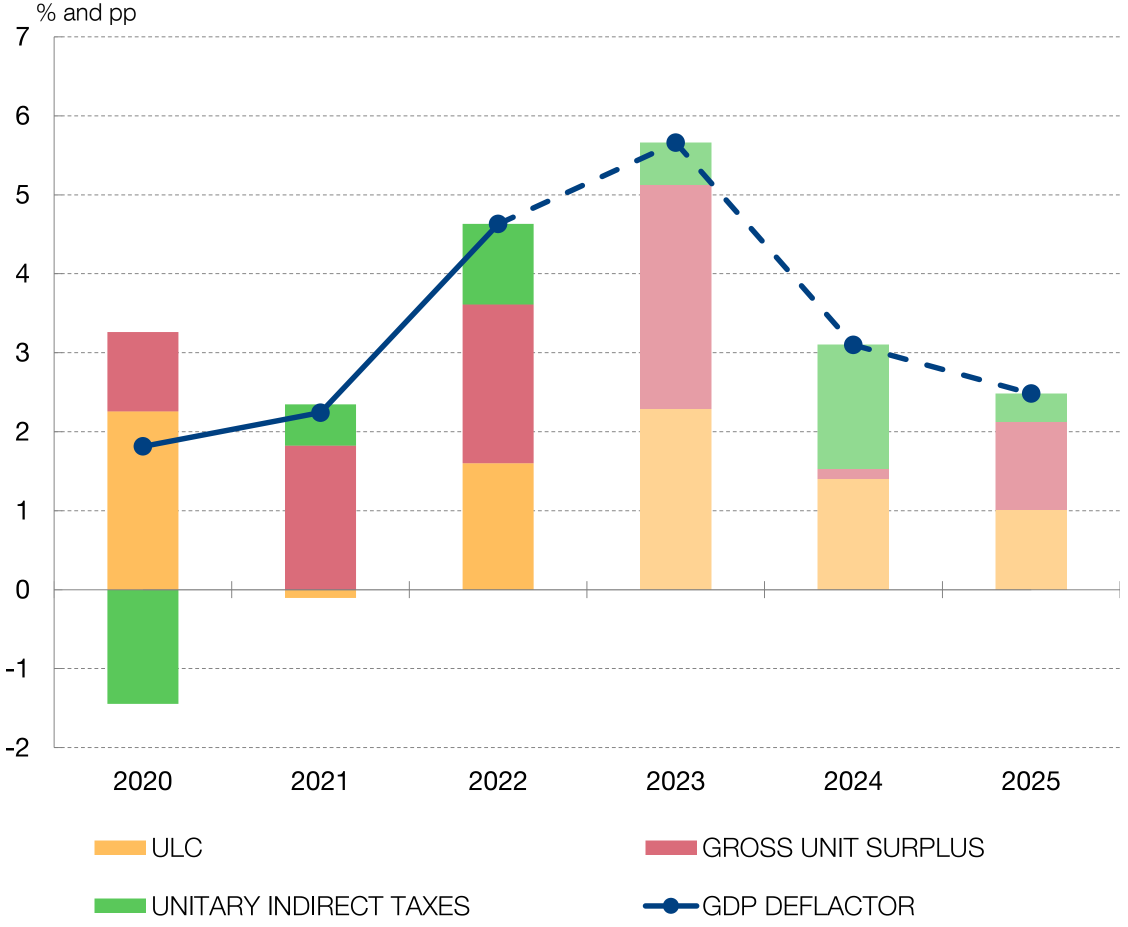
EMU. Forecasts (b)



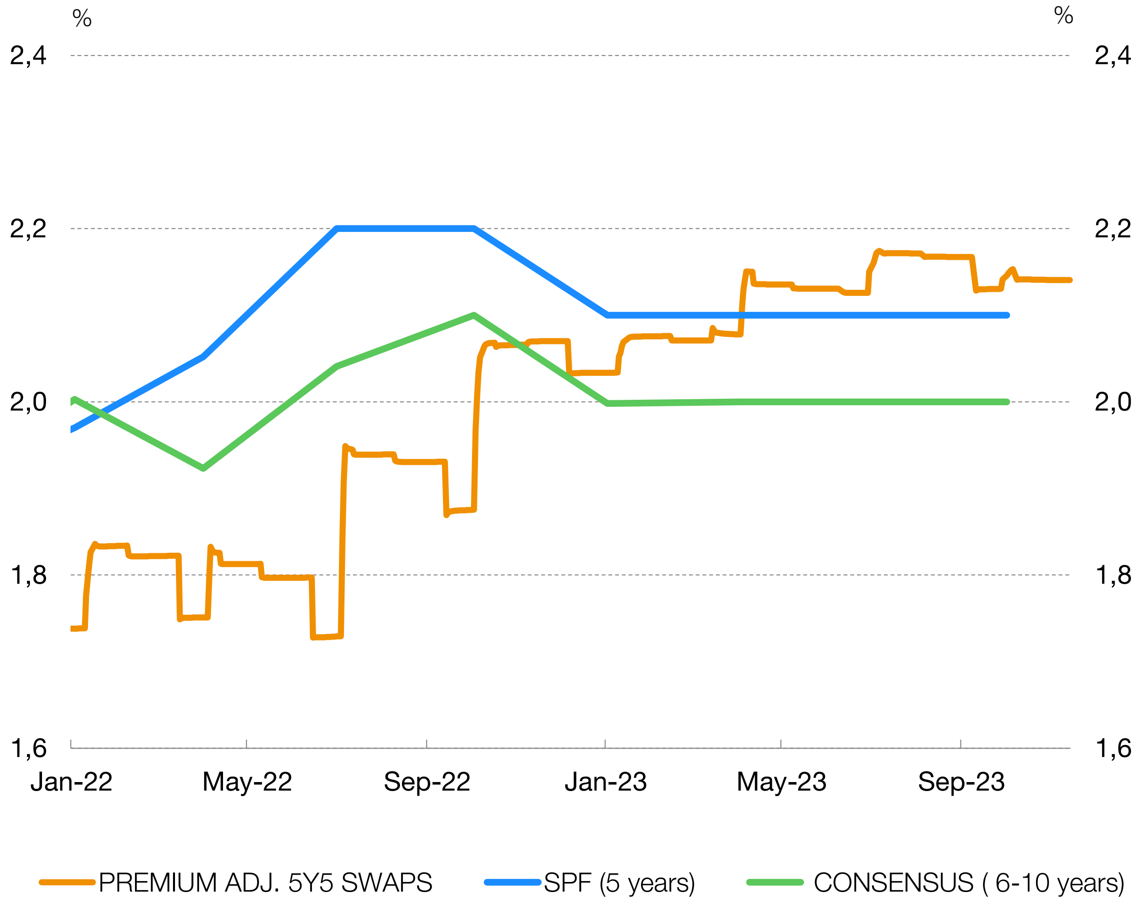
(a) Salary increases for the following 12 months.
(b) They include one-off payments.

Sources: ECB. Last observation: new signing agreements, August 2023.

EMU. Contributions to the GDP deflator (y-o-y variation) (a)



Analysts and market long-term expectations



(a) The unitary gross surplus is defined as the ratio between the gross operating surplus (EBE, including mixed incomes) and real GDP.

Sources: Bank of Spain, Consensus Economics, Eurosystem and Eurostat. Last observation: 14th November (swaps), October (Consensus) and 2023 IV (SPF).

Very weak growth is expected for the second half of 2023.

Headline and core inflation slow down is in line with expectations.

RISKS:

- **ACTIVITY: TILTED TO THE DOWNSIDE**
  - **DOWNSIDE :** Stronger-than-expected effects of monetary policy, further weakness in the global economy, and geopolitical risks (Ukraine, Middle East)
  - **UPSIDE:** tighter labor markets and real income increase

- **INFLATION: BALANCED**
  - **UPSIDE :** energy commodity price increase mainly in the short-run due to the geopolitical crisis in the Middle East, wage increases and higher-than-expected margins
  - **DOWNSIDE :** more intense transmission of monetary policy, greater weakness of the economy also on account of new geopolitical crisis

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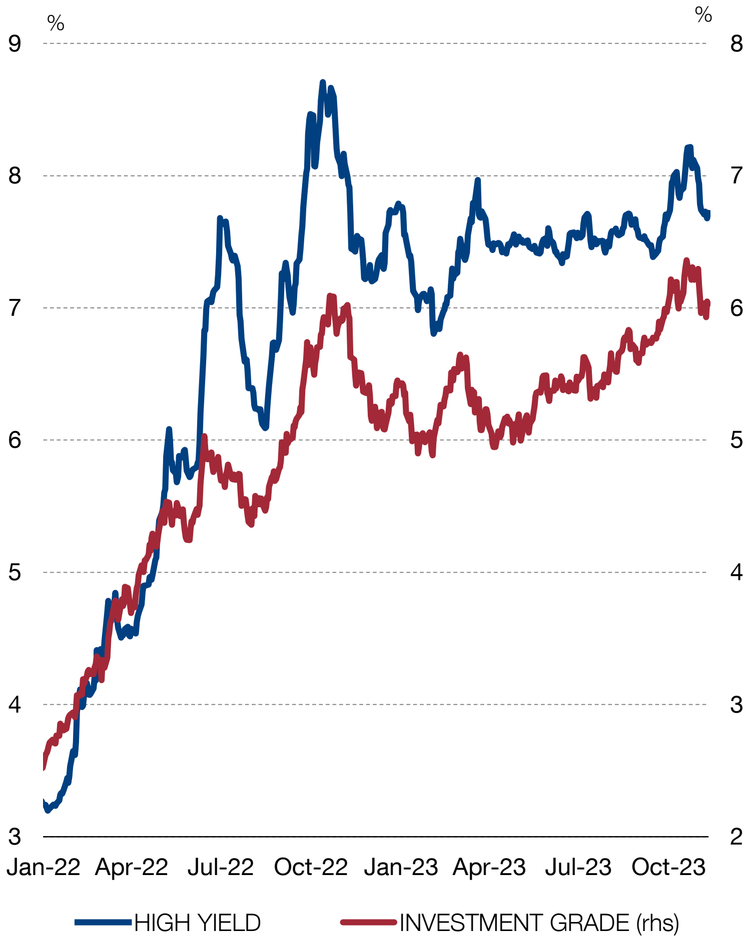
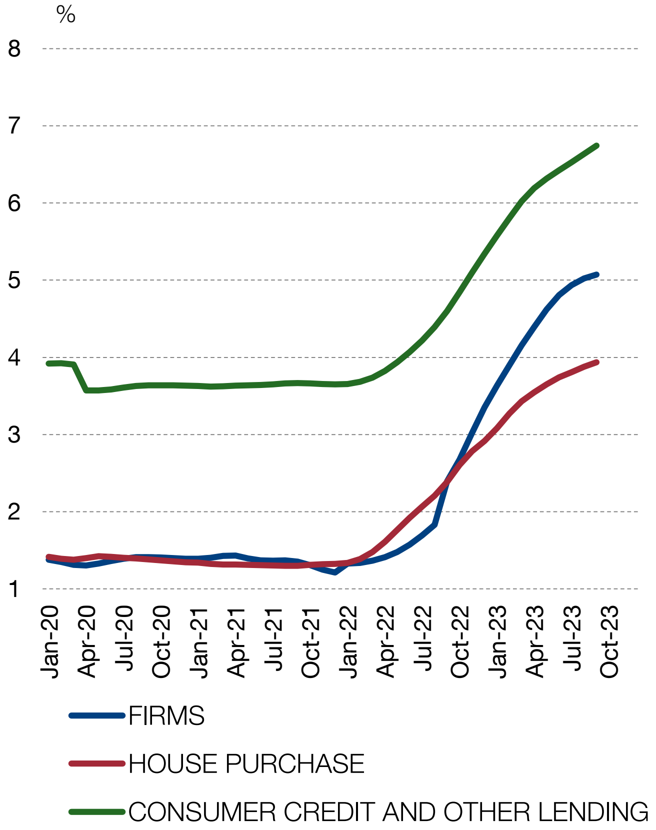
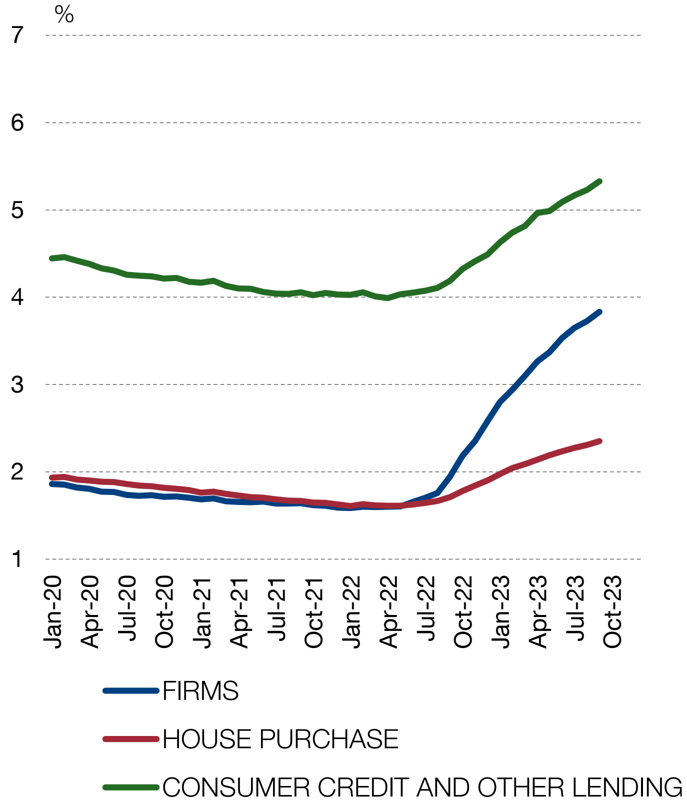
NFC Bond yields



Cost of new bank loans (a)



Lending rates on outstanding amounts



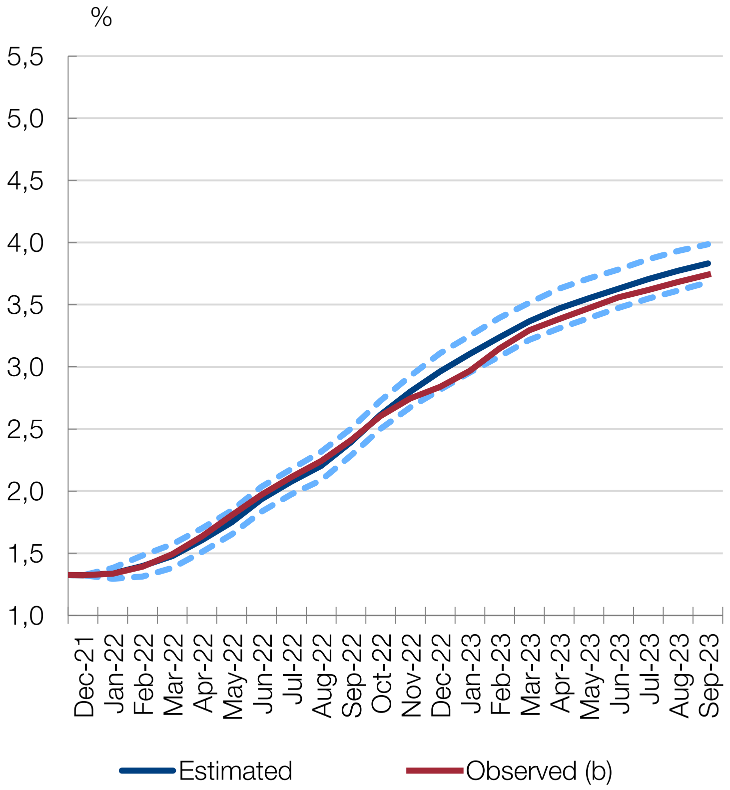
a. Narrowly defined effective rates (NDER) adjusted seasonally and for the irregular component.

SOURCES: European Central Bank and Refinitiv Datastream. Last observation: 10/11/2023.

BANK INTEREST RATE PASS-THROUGH IS BEING MORE INTENSE FOR FIRMS THAN IN OTHER HIKING CYCLES, WHEREAS IT IS BEING SLOWER IN THE CASE OF HOUSEHOLDS' TIME DEPOSITS

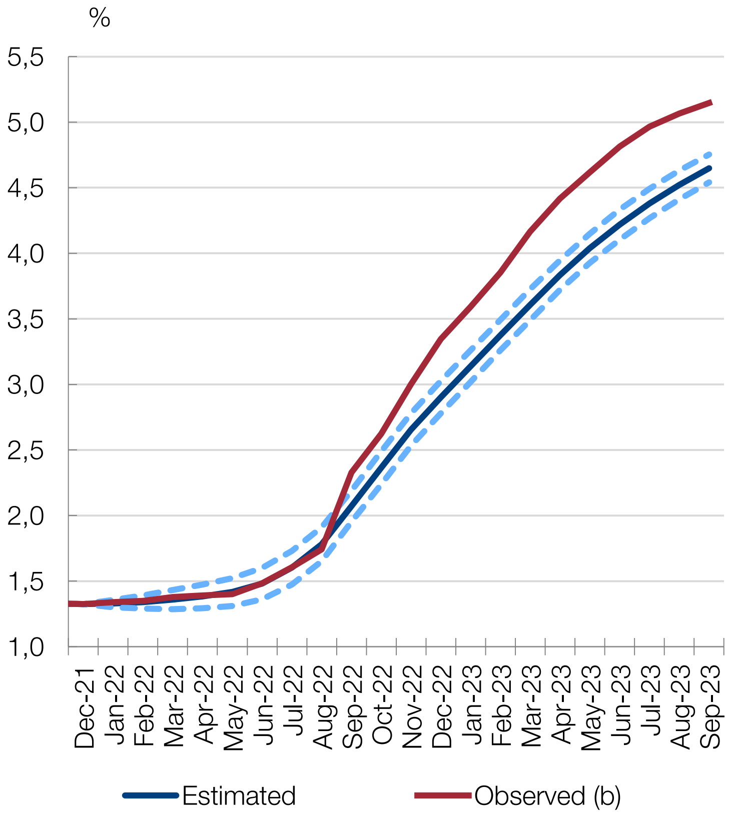
Loans to households for house purchase

Interest rate fixation period of over 1 year (a)



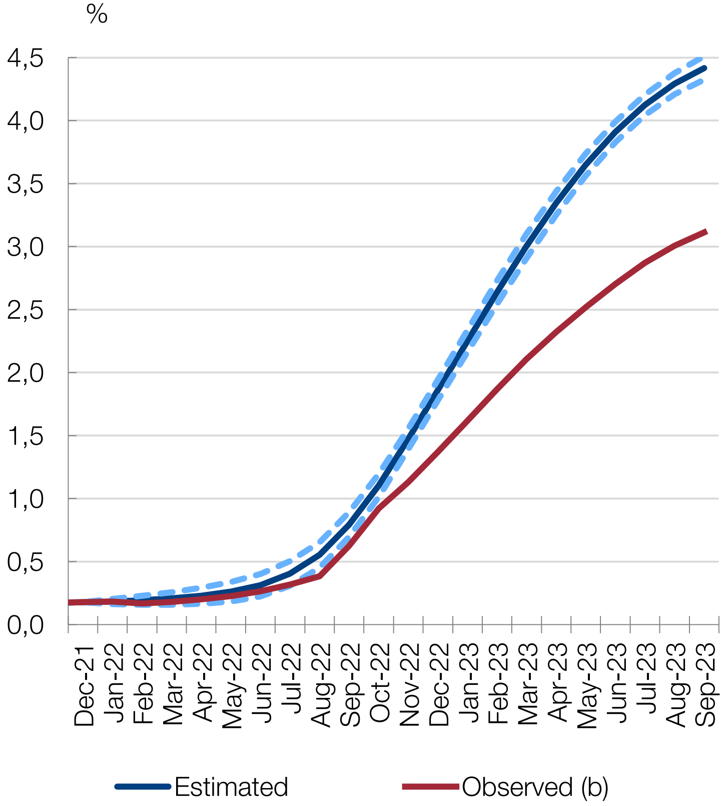
Loans to firms

Interest rate fixation period of up to 1 year (a)



Households' time deposits

Agreed maturity of up to 1 year (a)

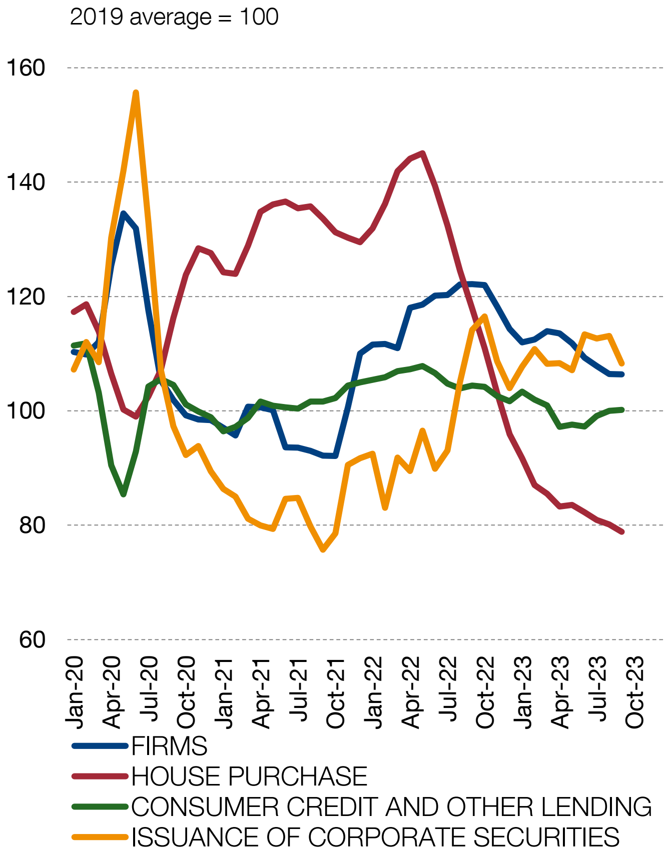


a. Interest rates are narrowly defined effective rates (NDER), which exclude related charges, such as repayment insurance premia and fees, and are adjusted seasonally and for the irregular component.
b. Resulting bank interest rate if the interest rate rise in the current cycle had been passed through at the same speed as in the previous cycle in 2005, as estimated based on standard error-correction models.

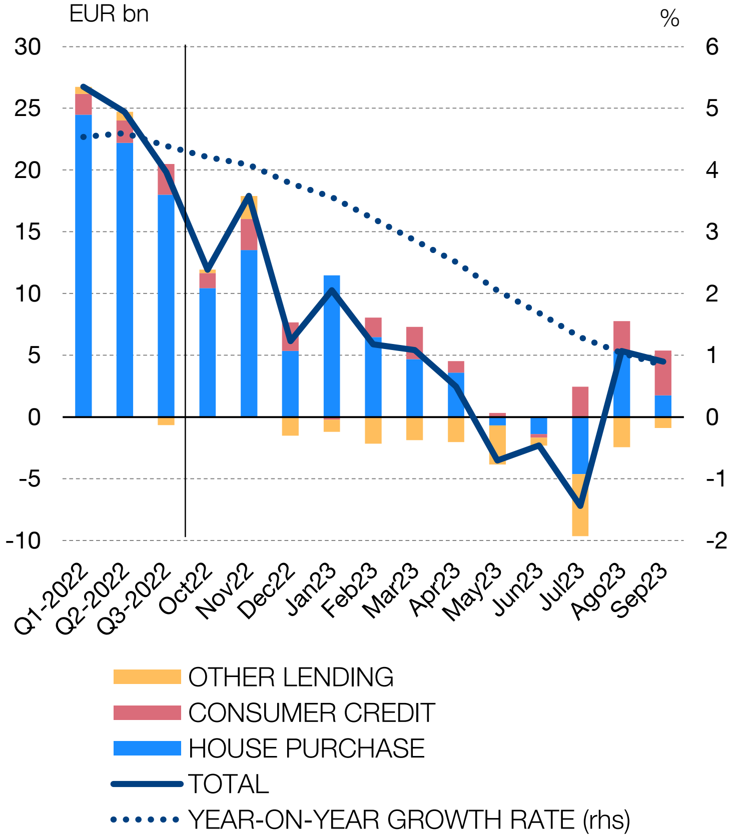
SOURCE: European Central Bank

THE YEAR-ON-YEAR GROWTH RATE OF CREDIT HAS REACHED ITS LOWEST LEVEL SINCE 2015, FALLING BELOW EXPECTATIONS

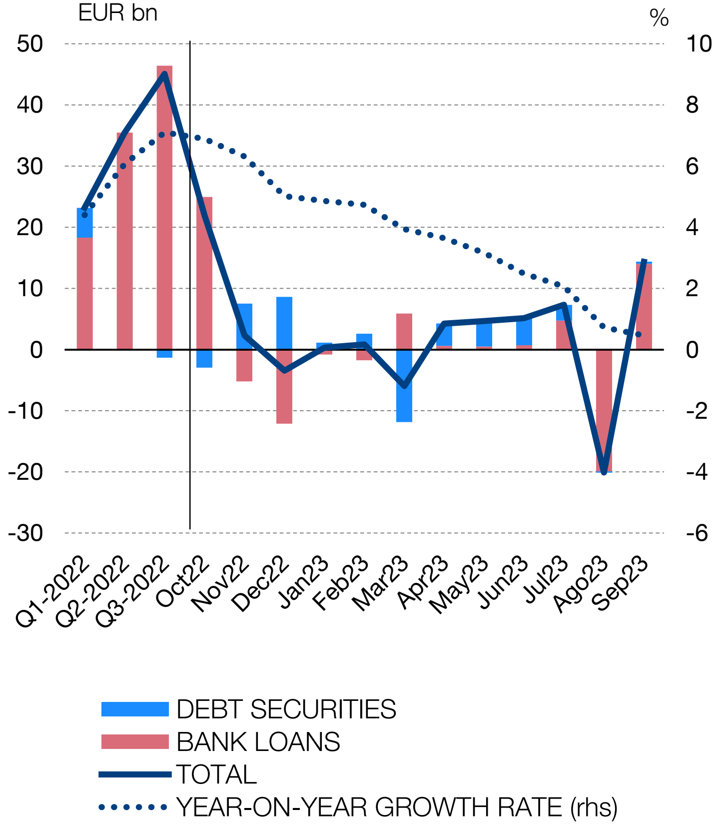
New financing flows (a)



Net financing flows. Households (b)



Net financing flows. Firms (b)

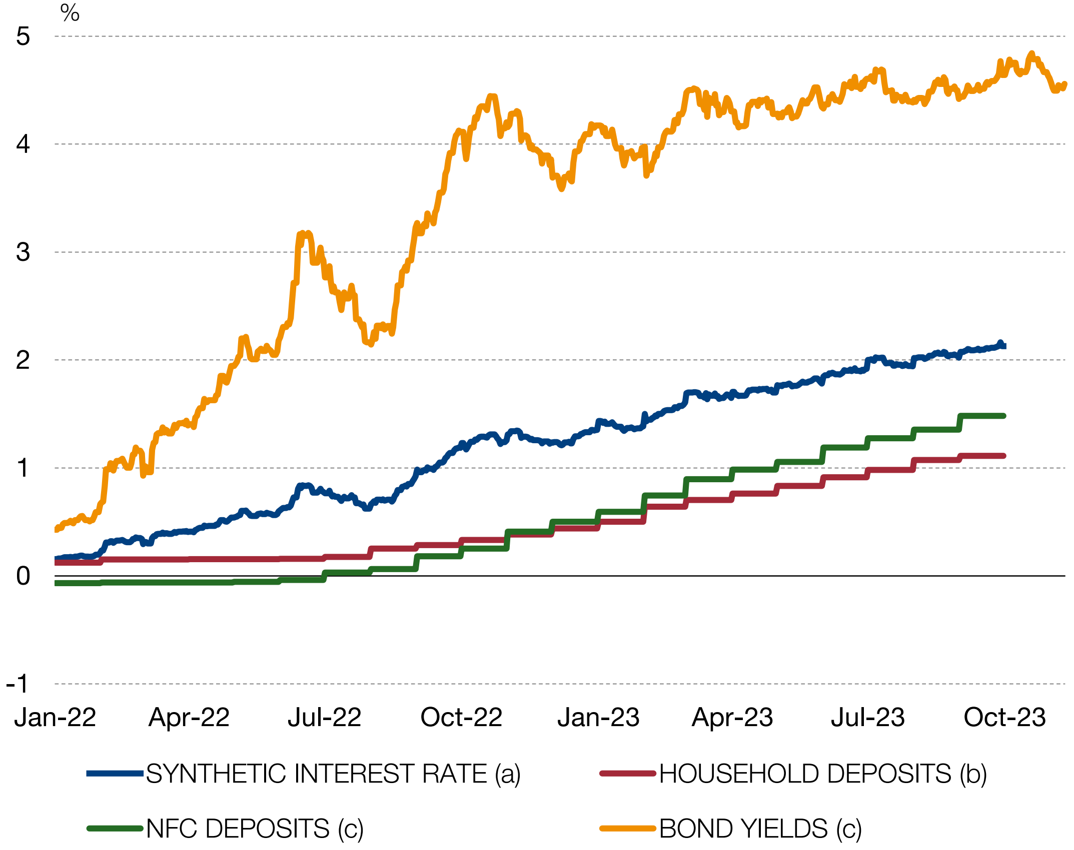


a. Seasonally adjusted three-month cumulative flows.
b. Seasonally adjusted monthly net flows. Bank loans are adjusted for securitisation.

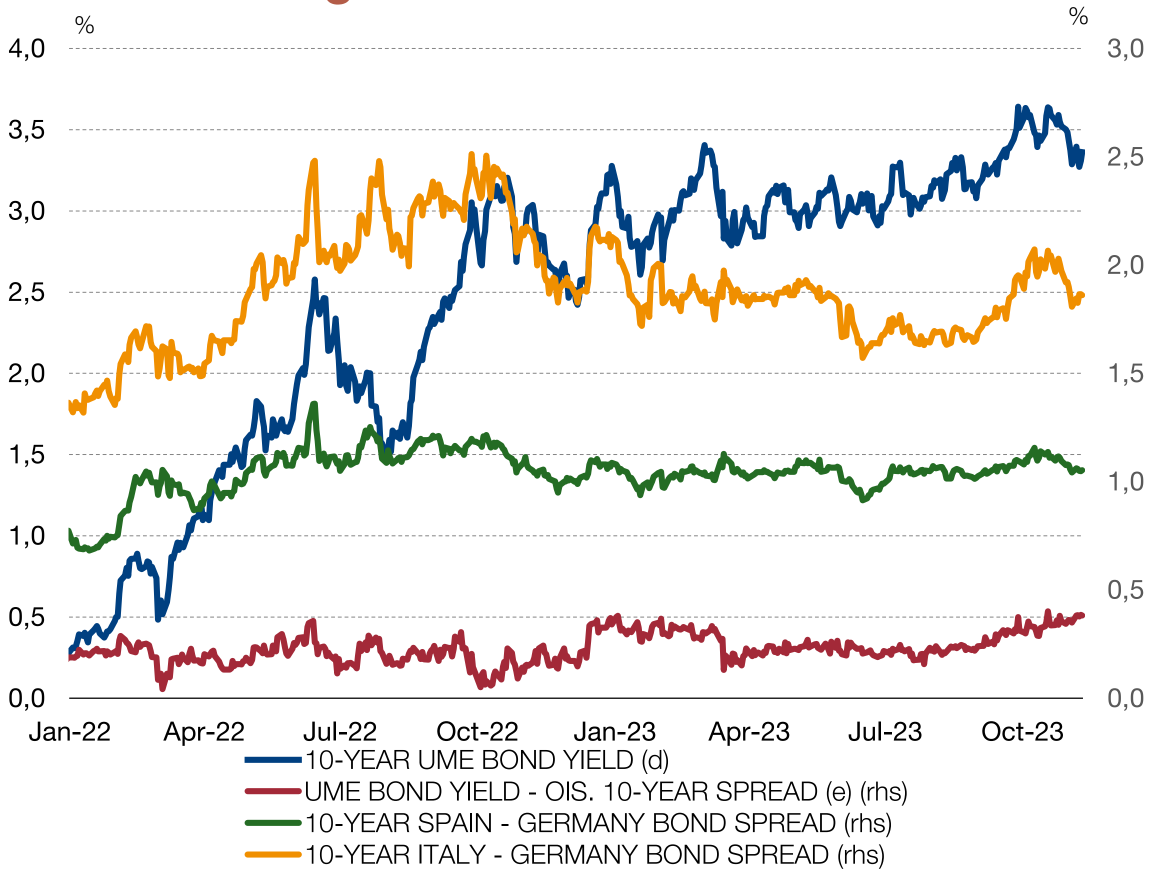
FUENTE: Banco Central Europeo

FINANCING COSTS OF BANKS AND SOVEREIGNS CONTINUE TO RISE, WITH AN INCREASE IN THE SPREAD OF ITALIAN SOVERING DEBT THAT HAS RECEDED RECENTLY

Financing costs. Banks



Financing costs. General Government



SOURCES: Refinitiv Datastream. Latest observed data: 10/11/2023 (bonds and OIS) and 30/09/2023 (others).
a. Calculated as a daily weighted average of deposit rates and bond yields. The weights are obtained from the balances of deposits and bonds recorded in the aggregate balance sheet of the EMU credit institutions.
b. Monthly interest rates on new deposits weighted by balances, represented daily.
c. "ICE BofA Euro Banking" index.
d. The EMU aggregate is calculated as the GDP-weighted average of the yields of the 16 countries included: Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Ireland, Finland, Portugal, Greece, Slovakia, Slovenia, Lithuania, Cyprus and Malta.
e. Spread between the average 10-year sovereign yield of the EMU countries, weighted by their GDP, and the 10-year OIS €STR.

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WHAT CAN WE EXPECT GOING FORWARD?

- **Since our Monetary Policy meeting in September, we have observed:**
  - **A materialization of the downside risks to economic growth in the euro area.**
    - Risks for the future remain on the downside.
  - **The evolution of inflation has been in line with expectations,** with a further decline in headline and core inflation.
    - Risks to inflation remain balanced.
  - **A further tightening of financial conditions, higher than expected,** confirming a very strong pass-through of our monetary policy.
    - Moreover, a significant part of the pass-through of monetary policy tightening is still pending.

- **Based on this assessment, the ECB's GC decided to keep the three key ECB interest rates unchanged and it considered that those levels, maintained for a sufficiently long duration, will make a substantial contribution to return inflation to its 2% target over the medium term.**
  - The high level of uncertainty requieres to keep our **data-dependent approach**.
  - In any case, **the key ECB interest rates will be set at sufficiently restrictive levels for as long as necessary** to ensure that inflation returns to its 2% medium-term target in a timely manner.
  - For the moment, **it is too early to talk about interest rates decreases**.

- **Geopolitical risks, in particular the potential extension of the war in the Middle East, remain the main determinant of economic developments and inflation in the euro area.**

  - Should this risk materialize, it could have a large negative effect on confidence and financial markets and, in particular, generate a significant increase in energy commodity prices, which would constitute a new negative supply shock.

- **The monetary policy reaction to the eventual materialization of such new supply shock could be different** from that which arose as a result of the war in Ukraine, given that, although in the short term it would generate an increase in inflation, from the perspective of medium-term inflation - which is relevant for the ECB- its effects could be much lower, given that**:**

  - **Monetary policy now maintains a clearly restrictive stance.** As an illustration, the interest rate on the deposit facility is 4% compared to -0.5% before the start of the war in Ukraine.
  - **Euro area activity is now very weak,** compared to the strong rebound it experienced after COVID and that accompanied the start of the Ukrainian war**.**

- **In order for monetary policy to have such a different reaction to the eventual materialization of this new negative supply shock, it would be crucial: (i) inflation expectations in the medium term to remain anchored at 2%; and (ii) second-round effects on wages and inflation to be limited.**

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THANK YOU FOR YOUR ATTENTION