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*English translation of the original speech in Spanish

Ladies and gentlemen,

I would like to thank the Governing Board of Spain Investors Day for inviting me to speak here today. This is my sixth year at an event that proves its usefulness, year after year, in discussing the economic situation in Spain. As we enter a new year, I would like to take this opportunity to explain the Banco de España's view on **the outlook for the Spanish economy**.

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To do so, we should begin by referring to the **international environment**, where recent developments are characterised by **three main trends**.

First, global economic activity has shown some buoyancy in recent quarters, despite a tightening of monetary policy and multiple geopolitical uncertainties. Indeed, 2023 Q3 was marked by upward surprises to GDP growth, particularly in the United States – thanks to strong employment and private consumption – and in China – amid greater fiscal support to counter the weakness of the real estate sector.

Nonetheless, activity was more lacklustre than expected in certain regions, such as the euro area and Japan. Global economic activity appears to have slowed in Q4, albeit relatively little and with signs of stabilisation.

Overall, global GDP growth decelerated markedly between 2022 and 2023, with considerable heterogeneity by region, **and is not expected to rebound in 2024.** The December Eurosystem projections, for example, anticipate global GDP growth of 3.3% in 2023 and 3.1% in 2024 (3.2% in 2025 and 2026), **below the historical average of the last two decades (3.8%)**.

Second, the disinflationary process has continued in recent months, in some areas even more strongly than expected. **Moreover, inflation rates are expected to continue falling** in the coming quarters, **an expectation that will fundamentally depend on whether an escalation in military conflicts**, which could significantly push up energy prices, **can be avoided.**

Against this background, central banks in emerging economies have continued to loosen their restrictive monetary policy stance, while their counterparts in **the main advanced economies have paused their interest rate hiking cycles**.

Third, global financial markets have seen sharp movements, with notable stock price gains and declines in long-term interest rates.

These developments have been strongly influenced by expectations about the future course of monetary policy, which have changed substantially in recent months, with stronger and earlier cuts in policy rates for 2024 expected in both the United States and the euro.[1]

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In the euro area, economic activity has remained notably weak and is only expected to pick up at a relatively slow pace. GDP declined by 0.1% in Q3 and the available indicators suggest it stagnated in Q4.

In fact, **the latest Eurosystem projections revised the growth outlook for 2023 and 2024 slightly downwards, to 0.6% and 0.8%, respectively (below potential growth)**, while the forecast for 2025 remained unchanged at 1.5%.[2]

Meanwhile, inflation has performed better than expected. After hitting a low of 2.4% in November, the flash estimate shows it rebounded to 2.9% in December, which was less than expected.[3] Underlying inflation declined by 0.2 percentage points (pp), to 3.4%, also below what was anticipated.

The deceleration in prices is expected to continue in the coming quarters, although in 2024 the decline is projected to be slower due to upward base effects and the phasing-out of the fiscal measures adopted during the energy crisis. The Eurosystem projections consider inflation to have been 5.4% in 2023 and expect it to ease to 2.7% in 2024 and to around 2% in 2025 and 2026.

Against this backdrop, after ten consecutive increases to September 2023, **the Governing Council of the European Central Bank has put a halt to the interest rate hiking cycle.** In addition, it is considered that **if we maintain interest rates at their current levels for long enough, we will achieve the 2% inflation target over the medium term.** This assessment is supported by the developments in inflation I mentioned earlier and by the projections, as well as the fact that monetary policy continues to be strongly passed through to financing conditions, even more so than expected.

The relevant question is **how long should interest rates be kept at their current levels before starting to gradually reduce them**. This will **depend on incoming data**, in a context in which **uncertainty remains high**.

A useful reference is that implicitly deriving from the Eurosystem projections, which expect inflation to converge to our target, based on market expectations about the course of interest rates on the cut-off date for the assumptions of the exercise (23 November 2023). On that date, the median analysts' expectations anticipated the first rate cut at the start of

[1] For example, markets now expect the first policy rate cut in the United States in May 2024 (as compared with four months ago, when they expected it in September 2024) and a cumulative reduction of between 125 and 150 basis points (bp) in 2024 (75 bp more than expected four months ago).

[2] The projected gradual road to recovery relies, above all, on private consumption, buoyed by the rise in households' real disposable income in an environment of rising wages and falling inflation. External demand is also expected to perform positively, although its contribution to growth will be limited by euro area exports' loss of market share.

[3] An analysis by component shows that the increase in headline inflation in December is exclusively due to lower declines in energy prices, partly offset by lower inflation in food and non-energy industrial goods, with that for services remaining unchanged.

2024 Q3 and the deposit facility rate to be around 3.25% by the end of 2024 and to reach 2% over the long term.

In any event, **attention will have to be paid in the coming months to a number of developments** that can affect the trajectory of inflation and, therefore, our monetary policy action. Specifically:

- **Risks to economic growth remain tilted to the downside.** In addition to **geopolitical developments, the transmission of monetary policy has been surprisingly strong**. If this continues over the coming years, it would result in lower growth. In fact, analysts' consensus for growth in 2024 is below that of the Eurosystem (0.5%).
- Moreover, **market rates have fallen sharply in recent weeks and are clearly below the path incorporated into the projections**, with markets now expecting a cumulative reduction of around 150 basis points (bp) in the deposit facility in 2024.
- The projections incorporate a gradual increase in real wages, which would regain the purchasing power lost in 2022 by end-2024. At the same time, productivity is expected to recover, leading unit labour costs to moderate. However, **labour markets remain tight, which could lead to higher wage pressures. Conversely, the fall in inflation may dampen wage demands.** In any event, a wealth of information will be received in the first months of 2024 on new collective bargaining agreements, which will make it possible to analyse the direction of these wage pressures.
- **Profit margins** are expected to narrow, as in Q3, given the weak demand and the resolution of bottlenecks. **Their future behaviour will be crucial for assessing their role in cushioning wage pressures.**
- Lastly, **fiscal policy could be instrumental in preventing inflationary pressures from rising.** Governments should withdraw the support measures taken in response to the energy crisis and the stance should be restrictive in 2024 and beyond to gradually reduce the high levels of fiscal imbalances observed in some countries.

In short, **the high level of uncertainty calls for us to continue to be very careful** to avoid both insufficient (which would prevent us from achieving our inflation target) and excessive tightening (which would unnecessarily harm activity and employment).

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In **Spain, economic activity has felt the effects of the global economic slowdown** in recent months and, in particular, of the situation in the euro area. Nonetheless, **it has displayed notable buoyancy.** Thus, the quarter-on-quarter growth rate declined gradually in 2023, to 0.3% in Q3, and the available data point to a similar decline in the fourth. In any event, at the end of the third quarter, Spanish GDP exceeded its pre-pandemic level by 2.1 pp, compared with 3 pp in the euro area.

This resilience has been underpinned, on the supply side, by the Spanish economy's strong sectoral structure – with a greater weight of better performing sectors, such as those related to tourism –, and by the lesser impact of rising energy prices on industry. On the demand side, the buoyancy of consumption has been the main factor bolstering economic activity. In addition, the Spanish economy has benefited from population growth, driven entirely by immigration flows.

Looking ahead, **according to the Banco de España's projections, GDP is expected to slow between 2023 and 2024** (from 2.4% to 1.6%) **before regaining some speed in 2025 and 2026**, when it will reach rates of 1.9% and 1.7%, respectively. As these rates are above potential growth, if confirmed they would gradually widen the output gap. From the standpoint of the composition of growth:

- **Activity is expected to be mainly underpinned by domestic demand.** In particular, **consumption will be boosted by the rise in real income**, against a backdrop of easing inflation rates.[4]
- **Gross capital formation is also expected to act as an important growth driver**, largely because of the effect of the projects linked to the NGEU programme, which should gather pace in 2024 and 2025.
- **Net external demand would recover**, after having made a marked negative contribution in the spring and summer of 2023. However, it is not expected to be able to drive GDP growth as forcefully as it did in 2022 and, to a lesser extent, in 2023.[5]
- **Employment will lose momentum**, in keeping with expected developments in activity and with the assumption that productivity will recover slightly.[6]

Meanwhile, **inflation has returned to a decelerating trend** in recent months, slowing to 3.3% in December, 0.2 pp down on the October figure.[7] **It is expected to rise slightly in early 2024 and to resume a downward path in the second half of the year.[8]** Overall, inflation is projected to average 3.4% in 2023, to subsequently ease to 3.3% in 2024 (and to around 2.0% in 2025 and 2026). The inflation profile will, in any event, **be closely tied to decisions regarding the expiry of the measures deployed to mitigate the impact of the energy crisis.**[9]

In any case, **uncertainty remains high** and **the risks to these economic growth projections remain tilted to the downside** while the risks to the **inflation projections are considered to be balanced**.

- As in the euro area, **the main sources of risk are the ongoing wars in Ukraine and in the Gaza Strip.**

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[4] According to the projections, by end-2024 or early 2025 real wages will recover the purchasing power lost owing to the energy shock.

[5] This is because the growing momentum projected for exports of goods and non-travel services (consistent with a gradual improvement in the external environment) will be offset by the recovery in imports (associated, among other factors, with the growth of gross fixed capital formation, which has a high import content) and by the slowdown in exports of travel services which have already exceeded their pre-pandemic levels.

[6] The unemployment rate is expected to continue to decline, albeit at a slower pace, owing to the moderating pace of job creation and the expected growth in the labour force, which will be driven by strong immigration flows.

[7] This is the result of the recent decrease in energy commodity prices and the continued downward trend in food prices and underlying inflation.

[8] This is essentially driven by the energy component and by the expiry of the energy tax cuts introduced by the authorities in 2022 and maintained in 2023. Meanwhile, food prices and underlying inflation are expected to continue to moderate over the projection horizon.

[9] The December projections did not factor in the effects of the Royal Decrees approved on 27 December, which extended the reduced VAT rate on electricity throughout 2024, and that of VAT on gas and the excise duty on electricity for the first three and six months of the year, respectively. These measures, if approved by Parliament, would further reduce inflation by around 0.4 pp in 2024, to below 3% on average, but they would push up inflation in 2025.

- Uncertainty also persists about **the impact of the monetary policy tightening measures** implemented to date.
- In Spain, these **projections are highly dependent of the execution of the NGEU programme**, which, as I said earlier, is expected to gather pace in 2024 and 2025.[10]
- **Unit labour costs have grown significantly in Spain**. Specifically, the rise in compensation per employee in the market economy (which has outpaced the wage increases negotiated in collective agreements), together with higher non-wage labour costs (in particular, social security contributions) and weak productivity, have led to unit labour costs rising **more than in other euro area countries since the start of the pandemic, which could ultimately affect the price competitiveness of Spanish firms**.
- The **still-high structural budget deficit and public debt levels** are a **source of vulnerability**, especially against a backdrop of rising borrowing costs.
- Moreover, the results of the latest Banco de España Business Activity Survey show that, **in the last quarter of 2023, and for the second quarter running, firms perceived a rise in economic policy uncertainty**, which adversely affected 60% of firms and became the number one constraint to economic activity reported by them. **Should these patterns persist, they could have a negative impact on business investment decisions** and on the future growth path.

In this setting, I would like to convey the following **main economic policy recommendations**:

- First, **fiscal policy should focus on gradually reducing the high levels of public debt**, which calls for a **restrictive fiscal stance** as early as 2024, which will need to be maintained in the coming years. The new European fiscal rules should make it easier to design a medium-term fiscal consolidation plan to improve the structural situation of Spain's public finances.
- **Second**, a fiscal policy designed to enhance productivity, accompanied by **ambitious structural reforms** and the investments needed to boost the capacity for growth (which would be supported by the full implementation of the NGEU programme), would help reduce price pressures in the medium term, increase potential growth and reverse the loss of convergence with Europe that has built up in recent decades.

[10] Although the Recovery and Resilience Facility tenders under this programme were awarded somewhat more slowly in 2023 than initially foreseen, the cumulative volume awarded in the first 10 months of the year was close to 40% higher than in the same period of 2022.