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MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

JUNE 2022

BPI

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June 2022

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Portugal: There are cushions, but the clouds thicken

This month we reviewed the scenario for the Portuguese economy. It was a substantial revision, improving the outlook for 2022, albeit with a downward trend in the long term. In fact, we must recognise the very significant growth in recent quarters, especially the first quarter of 2022, which surprised us; and the systematic improvement of the labour market, where the unemployment rate is around the lowest in the last 20 years. However, risks are also significant and challenges have been intensifying, leading us to warn that this is an upward revision... but from more to less.

With regard to activity, we now expect GDP to grow by 6.6% in 2022, incorporating the result for the first quarter (quarterly increase of +2.6%) and very slight growth until the end of the year. Note that with this starting point, if the economy stagnates between April and December, annual GDP would still be around 6.3%. However, given the various cushions that exist, such a weak performance does not seem likely. Firstly, looking at the savings accumulated over the last two years, where activity was constrained by the pandemic and favourable economic policies supported work and income. We estimated that by the end of 2021 they would represent around 2.5% of GDP. Given the significant increase in the consumption of durable goods in the first months of the year, it is possible that this figure has declined, but it should still be significant. The second aspect to consider is the very favourable behaviour of the labour market. The number of people in employment has already exceeded pre-pandemic levels. Furthermore, the unemployment rate is currently below 6% and has been at its lowest rate since 2002 in the first months of the year. Another important cushion is the return of tourism. Effectively, April was the first month in which tourist numbers exceeded pre-pandemic levels. However, in the accumulated12 month period, around 25% of that level has yet to be recovered, which is a lot. If the positive trend continues, this recovery will bring added stimulus to the economy. Supporting this perspective, it should be noted that some surveys on travel intentions in the main markets that send tourists to the Portuguese market predict strong summer months for the sector.

Other factors justify optimism when assessing prospects. For example, more structural and less visible factors. These include the evolution of goods exports, which exceeded pre-pandemic levels in volume in the first quarter of this year (this analysis excludes the effects of price increases). There has also been an increase in market share over at least the past five years. This means that goods exports have grown above demand in destination markets, signalling an increase in competitiveness. From another perspective, there are no signs of an increase in default, despite the end of the moratoriums at the end of 2021. These moratoriums, which covered more than 30% of corporate loans, made it possible to defer debt payments without a breach of contract. This is a sign of the strength of the business sector, although there may be specific cases of sectors and companies that have been more affected by the pandemic, with effects that may still emerge, but that should be limited in scope. Community funds should also be mentioned, although their implementation may be hampered by current constraints relating to the cost of materials and lack of manpower. Together, these amounts are significant and should drive growth in the coming years.

Despite these cushions, the challenges are enormous due to rising interest rates, very high inflation (8% in May) and the prospect of a cooling in foreign demand, among other factors, due to the war in Ukraine. In particular, the rise in interest rates should have a significant impact in the long term, as the Portuguese economy remains heavily in debt. Despite deleveraging in the private sector, the fact that around 90% of loans to individuals remain indexed to a variable interest rate, which is subject to Euribor rates, suggests that families' share of the debt burden will increase in the long term, as debt will absorb a greater share of their income. Although public sector interest rates start from a very low base rate (interest on public debt amounted to 2.4% of GDP in 2021, compared to 4.9% of GDP in 2021), the increase in this debt share will also affect fiscal policy in the future as public debt, which remains above pre-pandemic levels (127% of GDP in 2021), will have to be consolidated and reduced.

Finally, there are some cushioning factors that could lead to growth of more than 6% this year, although a slowdown in 2023 is inevitable. For now, our forecasts have been changed to 2%, with risks (still) balanced. However, the clouds are thickening on the horizon.

Paula Carvalho

Chronology

MAY 2022

7 The Taliban make the Islamic face veil compulsory for women.
22-26 World Economic Forum in Davos.
25 Mass shootings at a US elementary school.

APRIL 2022

1-31 The Russia-Ukraine war continues as Russia suspends gas supplies to Bulgaria and Poland.
China places numerous cities in lockdown to curb the new COVID outbreak.
24 Emmanuel Macron is re-elected president of France.

MARCH 2022

1-31 The war in Ukraine, the peace negotiations and the sanctions continue.
Refugee crisis (more than 4 million Ukrainians have taken refuge outside Ukraine).
23 The Taliban maintain the ban on women's secondary education.

FEBRUARY 2022

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24 Russian invasion of Ukraine.
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JANUARY 2022

1 Sixth wave of COVID in Spain.
23 A Taliban delegation begins talks with European powers and the US in Oslo.
24 The James Webb telescope reaches its final destination from which it will study the origins of the universe.

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3 The European Commission authorises the disbursement of 10 billion euros of NGEU funds to Spain.
8 Tension rises in the Ukraine crisis.
28 An agreement is reached on labour reform in Spain.

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JUNE 2022

2 Spain: registration with Social Security and registered unemployment (May).
8 Portugal: turnover in industry (April).
9 Governing Council of the European Central Bank meeting.
10 Spain: Fitch rating.
14-15 Federal Open Market Committee meeting.
16 Spain: quarterly labour cost survey (Q1).
23 Spain: loans, deposits and NPL ratio (Q1 and April).
Portugal: home prices (Q1).
23-24 European Council meeting.
24 Spain: quarterly national accounts (Q1).
Spain: balance of payments and NIIP (Q1).
Portugal: household savings rate (Q1).
29 Spain: CPI flash estimate (June).
Portugal: employment and unemployment (May).
Euro area: economic sentiment index (June).
30 Spain: household savings rate (Q1).
Spain: state budget execution (May).
Portugal: NPL ratio (Q1).

JULY 2022

1 Portugal: industrial production (May).
4 Spain: registration with Social Security and registered unemployment (June).
5 Portugal: new lending (May).
11 Spain: financial accounts (Q1).
Portugal: international trade (May).
15 China: GDP (Q2).
21 Governing Council of the European Central Bank meeting.
Portugal: non-financial private sector lending (May).
26 Spain: loans, deposits and NPL ratio (May).
26-27 Federal Open Market Committee meeting.
28 Spain: labour force survey (Q2).
Euro area: economic sentiment index (July).
US: GDP (Q2).
29 Spain: GDP flash estimate (Q2).
Spain: CPI flash estimate (July).
Spain: state budget execution (June).
Portugal: GDP flash estimate (Q2).
Euro area: GDP (Q2).

Changing times for economic policy

Global economies continue to deal with the effects of a triple "shock" in world supply (bottlenecks, wars and zero-Covid policies) that keep raw material prices under pressure, undermine economic agents' confidence and trigger alerts on financial markets leading to an increase in volatility and significant downturns in share prices. Despite all this and the lack of information published in the second quarter, it seems that economic activity remains in positive territory thanks to the services sector, which has performed well, the strength of the labour market in many countries and the excess savings accumulated over the past two years. Uncertainty continues to weigh heavily on both investors and consumers and, although the cycle of economic activity has so far proven to be highly resilient, there is still a lot to play for before the end of the year.

In this context, central banks are already accelerating the tightening of financial conditions in an attempt to eliminate pressures from the demand side, at least while supply remains subject to all kinds of obstacles. Interest rate hikes have been widespread (with exceptions such as Japan) in an attempt to minimise the risk of secondary effects, which become more pronounced as underlying inflation approaches 5% (and more in the USA). It is not easy to forecast how prices will behave in such an unusual scenario where so many "shocks" are happening at once. The decline in economic activity and the base effects on prices expected towards the end of this year could significantly narrow the gap for central bank targets. However, this will probably not be enough and, in any case, risk is not balanced, as it will not be easy to distribute the marked deterioration in disposable income that we are already witnessing equally between sectors (income policy).

Therefore, the high levels of uncertainty that continue to characterise the economy will particularly affect monetary policy, which will either be successful or fall short when it comes to addressing such a complex situation, especially given the delays involved. However, it is clear that, in the short term, it is not easy for monetary policy to restore the balance between supply and demand. In any case, the change in monetary policy since the beginning of the year was crucial, as it kept price expectations anchored in a context of continuous negative inflation surprises. In this context, the most important development in recent weeks is the change in the ECB's strategy which, by anticipating rate increases at the July and September meetings, reflects that the balance of risks has begun to constitute a clear threat to its medium-term inflation objective. This stance helped to prevent the Euro from losing more ground against the Dollar and reach a position of near parity. In a world subject to of all kinds changes and where, not so long ago, there was the threat of a currency war, it seems that central banks are once again taking the strength of exchange rates into account, both as regards their positive effect on inflation and the confidence they convey to investors who have been heavily penalised since the beginning of the year by the downturns in both bond markets and stock markets, which nullified the protection that traditional portfolio diversification strategies usually offer.

With monetary policy heading at least towards a neutral zone, which could mean interest rate levels in the range of 2.75% to 3% in the US and 1.25% to 1.75% in Europe, the big question is what role fiscal policy can and should play and, therefore, whether the economic policy response will be balanced. After the initial logical response to the energy shock caused by the war, fiscal policies seem to be in no man's land, caught between the effects of the budget packages approved two years ago, doubts about the next steps to be taken in the short term and fear of the risk of fragmentation. This is logical, bearing in mind that the monetary normalisation process will involve a change in the rules of the game and greater investor attention to fiscal solvency, as we are already witnessing with the increase in the risk premium of peripheral countries, especially Italy. Likewise, although the implementation of the European Stability Pact remains suspended next year, the recommendation is to return to a neutral fiscal policy (with spending growing less than potential growth) while the new rules that will enter effect in 2024 are designed. In any case, maintaining a markedly expansionary fiscal tone in a context such as the one we have at the moment would make monetary policy less effective at tackling the inflation problem. Historical experience tells us that it is a good idea for monetary and fiscal policies to go hand in hand.

Average for the last month in the period, unless otherwise specified

Financial markets

	Average 2000-2007	Average 2008-2018	2019	2020	2021	2022	2023
INTEREST RATES							
Dollar							
Fed funds (upper limit)	3.43	0.68	1.75	0.25	0.25	2.75	3.00
3-month Libor	3.62	0.90	1.91	0.23	0.21	2.90	2.95
12-month Libor	3.86	1.40	1.97	0.34	0.52	3.40	3.25
2-year government bonds	3.70	0.95	1.63	0.13	0.62	2.75	2.60
10-year government bonds	4.70	2.61	1.86	0.93	1.45	3.15	3.10
Euro							
ECB depo	2.05	0.26	–0.50	–0.50	–0.50	0.25	1.00
ECB refi	3.05	0.82	0.00	0.00	0.00	0.75	1.50
Eonia	3.12	0.47	–0.46	–0.47	–0.49	0.35	1.35
1-month Euribor	3.18	0.58	–0.45	–0.56	–0.60	0.35	1.32
3-month Euribor	3.24	0.74	–0.40	–0.54	–0.58	0.43	1.37
6-month Euribor	3.29	0.88	–0.34	–0.52	–0.55	0.65	1.39
12-month Euribor	3.40	1.07	–0.26	–0.50	–0.50	0.88	1.42
Germany							
2-year government bonds	3.41	0.45	–0.63	–0.73	–0.69	0.90	1.45
10-year government bonds	4.31	1.70	–0.27	–0.57	–0.31	1.25	1.85
Spain							
3-year government bonds	3.62	1.87	–0.36	–0.57	–0.45	1.51	2.01
5-year government bonds	3.91	2.39	–0.09	–0.41	–0.25	1.72	2.21
10-year government bonds	4.42	3.40	0.44	0.05	0.42	2.45	2.85
Risk premium	11	171	71	62	73	120	100
Portugal							
3-year government bonds	3.68	3.66	–0.34	–0.61	–0.64	1.62	2.18
5-year government bonds	3.96	4.30	–0.12	–0.45	–0.35	1.88	2.38
10-year government bonds	4.49	5.03	0.40	0.02	0.34	2.45	2.85
Risk premium	19	334	67	60	65	120	100
EXCHANGE RATES							
EUR/USD (dollars per euro)	1.13	1.28	1.11	1.22	1.13	1.10	1.18
EUR/GBP (pounds per euro)	0.66	0.84	0.85	0.90	0.85	0.84	0.84
OIL PRICE							
Brent ($/barrel)	42.3	81.6	65.2	50.2	74.8	100.5	85.0
Brent (euros/barrel)	36.4	62.9	58.6	41.3	66.2	92.3	72.4

Forecasts

Change in the average for the year versus the prior year average (%), unless otherwise indicated

International economy

	Average 2000-2007	Average 2008-2018	2019	2020	2021	2022	2023
GDP GROWTH							
Global	**4.5**	**3.4**	**2.9**	**–3.1**	**6.1**	**3.2**	**3.7**
Developed countries	***2.6***	***1.4***	***1.8***	***–4.5***	***5.2***	***2.7***	***2.3***
United States	2.7	1.6	2.3	–3.4	5.7	2.4	1.9
Euro area	2.2	0.8	1.6	–6.5	5.4	2.6	3.0
Germany	1.6	1.3	1.1	–4.9	2.9	1.2	2.8
France	2.2	0.9	1.8	–8.0	7.0	2.8	2.3
Italy	1.5	–0.4	0.5	–9.1	6.6	2.4	2.0
Portugal	1.5	0.3	2.7	–8.4	4.9	6.6	2.0
Spain	3.7	0.5	2.1	–10.8	5.1	4.2	3.8
Japan	1.4	0.5	–0.2	–4.5	1.7	1.7	1.6
United Kingdom	2.6	1.3	1.7	–9.3	7.4	3.6	0.1
Emerging and developing countries	***6.5***	***5.0***	***3.7***	***–2.0***	***6.8***	***3.6***	***4.7***
China	10.6	8.2	6.0	2.2	8.1	3.7	5.2
India	7.2	7.0	4.5	–6.7	9.0	7.5	7.5
Brazil	3.6	1.7	1.2	–3.9	4.6	0.8	2.1
Mexico	2.4	2.1	–0.2	–8.2	4.8	1.9	2.3
Russia	7.2	1.2	2.2	–2.7	4.8	–8.1	–0.3
Turkey	5.5	4.9	0.9	1.8	11.0	3.3	3.9
Poland	4.2	3.5	4.8	–2.1	6.0	5.7	3.3
INFLATION							
Global	**4.1**	**3.7**	**3.5**	**3.2**	**4.7**	**7.1**	**4.2**
Developed countries	***2.1***	***1.6***	***1.4***	***0.7***	***3.1***	***5.9***	***2.2***
United States	2.8	1.8	1.8	1.3	4.7	7.0	2.5
Euro area	2.2	1.4	1.2	0.3	2.6	6.8	2.3
Germany	1.7	1.4	1.4	0.4	3.2	6.9	2.4
France	1.9	1.3	1.3	0.5	2.1	5.2	1.7
Italy	2.4	1.5	0.6	–0.1	1.9	6.2	1.9
Portugal	3.1	1.2	0.3	0.0	1.3	6.0	2.2
Spain	3.2	1.4	0.7	–0.3	3.1	6.8	1.1
Japan	–0.3	0.4	0.5	0.0	–0.2	1.5	0.8
United Kingdom	1.6	2.4	1.8	0.9	2.6	6.8	2.5
Emerging countries	***6.7***	***5.6***	***5.1***	***5.2***	***5.9***	***8.0***	***5.6***
China	1.7	2.6	2.9	2.5	0.9	2.1	1.8
India	4.5	7.7	3.7	6.6	5.1	5.4	4.5
Brazil	7.3	5.9	3.7	3.2	8.3	8.7	4.7
Mexico	5.2	4.2	3.6	3.4	5.7	6.2	4.0
Russia	14.2	8.2	4.5	3.4	6.7	14.0	7.5
Turkey	22.6	9.1	15.2	12.3	19.6	52.3	23.4
Poland	3.5	1.9	2.1	3.7	5.2	8.8	5.1

Forecasts

Change in the average for the year versus the prior year average (%), unless otherwise indicated

Portuguese economy

	Average 2000-2007	Average 2008-2018	2019	2020	2021	2022	2023
Macroeconomic aggregates							
Household consumption	1.7	0.3	3.3	–7.1	4.5	5.9	2.4
Government consumption	2.3	–0.5	2.1	0.4	4.1	1.7	0.2
Gross fixed capital formation	–0.4	–1.2	5.4	–2.7	6.4	5.1	6.7
Capital goods	3.2	2.7	1.6	–6.2	12.5	–	–
Construction	–1.5	–3.5	7.7	1.6	4.0	–	–
Domestic demand (vs. GDP Δ)	1.3	–0.2	3.0	–5.6	5.1	5.1	2.9
Exports of goods and services	5.2	4.0	4.1	–18.6	13.1	12.8	5.0
Imports of goods and services	3.6	2.5	4.9	–12.1	12.9	8.6	6.9
Gross domestic product	**1.5**	**0.3**	**2.7**	**–8.4**	**4.9**	**6.6**	**2.0**
Other variables							
Employment	0.4	–0.6	1.2	–1.9	2.7	1.7	0.5
Unemployment rate (% of labour force)	6.1	11.8	6.6	7.0	6.6	5.9	5.7
Consumer price index	3.1	1.2	0.3	0.0	1.3	6.0	2.2
Current account balance (% GDP)	–9.2	–3.2	0.4	–1.2	–1.1	–2.2	–1.1
External funding capacity/needs (% GDP)	–7.7	–1.9	1.2	0.1	0.7	0.1	1.2
Fiscal balance (% GDP)	–4.6	–5.6	0.1	–5.8	–2.8	–1.7	–0.7

Forecasts

Spanish economy

	Average 2000-2007	Average 2008-2018	2019	2020	2021	2022	2023
Macroeconomic aggregates							
Household consumption	3.6	–0.1	0.9	–12.2	4.7	–0.2	5.2
Government consumption	5.0	1.0	2.0	3.3	3.1	0.6	0.3
Gross fixed capital formation	5.6	–1.9	4.5	–9.6	4.3	6.6	4.7
Capital goods	4.9	0.0	3.2	–12.9	16.0	10.7	4.1
Construction	5.7	–3.8	7.1	–9.6	–2.8	2.6	5.2
Domestic demand (vs. GDP Δ)	4.4	–0.4	1.5	–9.0	5.0	1.4	3.9
Exports of goods and services	4.7	2.9	2.5	–20.2	14.7	13.0	2.1
Imports of goods and services	7.0	0.1	1.2	–15.2	13.9	5.4	2.5
Gross domestic product	**3.7**	**0.5**	**2.1**	**–10.8**	**5.1**	**4.2**	**3.8**
Other variables							
Employment	3.2	–0.7	2.6	–7.6	6.7	3.8	2.9
Unemployment rate (% of labour force)	10.5	20.0	14.1	15.5	14.8	13.6	12.5
Consumer price index	3.2	1.4	0.7	–0.3	3.1	6.8	1.1
Unit labour costs	3.0	0.3	3.1	4.9	1.1	2.2	2.2
Current account balance (% GDP)	–5.9	–0.5	2.1	0.8	0.9	0.1	1.3
External funding capacity/needs (% GDP)	–5.2	–0.1	2.0	1.8	1.6	1.7	1.7
Fiscal balance (% GDP)[1]	0.3	–6.9	–3.1	–10.3	–6.9	–5.5	–4.8

Note: *1. Excludes losses for assistance provided to financial institutions.*

Forecasts

Fears of recession shake the financial markets

Investor sentiment remains very fragile. The financial markets continued to operate in a scenario of high uncertainty and volatility. Three months after Russia launched its invasion of Ukraine, the conflict is no longer cited as the main risk factor among investors, having been overshadowed by concerns about the signs of weakening in the global economic recovery and, most importantly, about the urgency for the central banks to withdraw the monetary stimulus in the face of the persistent inflationary pressures. Fears of a hard landing fuelled increased demand for safe-haven assets and a flight of capital from risky assets. The turbulence in the markets is tightening in the financial conditions, becoming yet another headwind in what is already a difficult global macroeconomic scenario.

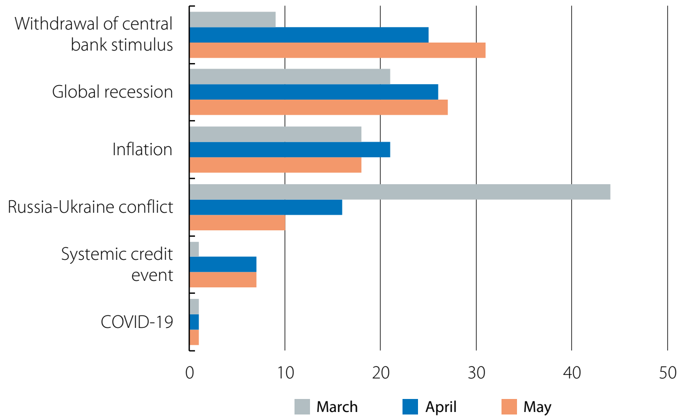
Stock-market sell-off, appreciation of the dollar and correction of sovereign yields. In this context, the international stock markets fell significantly for much of May, although this trend reversed in the closing days of the month. The decline was most pronounced in the US indices, where the S&P 500 amounted a 14% decline compared to the peak at the beginning of the year, equivalent to half of the losses suffered during the first wave of COVID-19 in the spring of 2020. In Europe, the trend has been more mixed, with cumulative declines from the peak of 12% in the German DAX and 4% in the Spanish IBEX. The high volatility was also reflected in the currency markets, with the dollar appreciating to 1.038 against the euro, although it subsequently yielded and closed the month at around 1.07. Sovereign debt yields, meanwhile, registered a sharp correction in the US (–9 bps to 2.84% for the 10-year bond), but rose in Germany (+18 bps to 1.1%), while the risk premia on the debt of the euro area periphery increased.

Consensus in the ECB to raise rates in July. In the euro area, the intensification of inflationary pressures triggered a hardening of the ECB's narrative with a view to removing the monetary expansion measures. Its members' statements thus now assume that net asset purchases will cease this quarter, while also indicating that there is consensus to initiate the rate hike cycle in July. In a post on the central bank's website, its president, Christine Lagarde, stated that she expects the period of negative rates to end as early as Q3, although she also emphasised that the normalisation process will be carried out gradually and flexibly. In contrast, the more hawkish members of the Governing Council have raised the possibility of more aggressive rate hikes in the short-term, in line with the implicit rates reflected in the money markets (increases of 100 bps this year).

The Fed raises rates by 50 bps and announces the reduction of its balance sheet. Meanwhile, at its much-

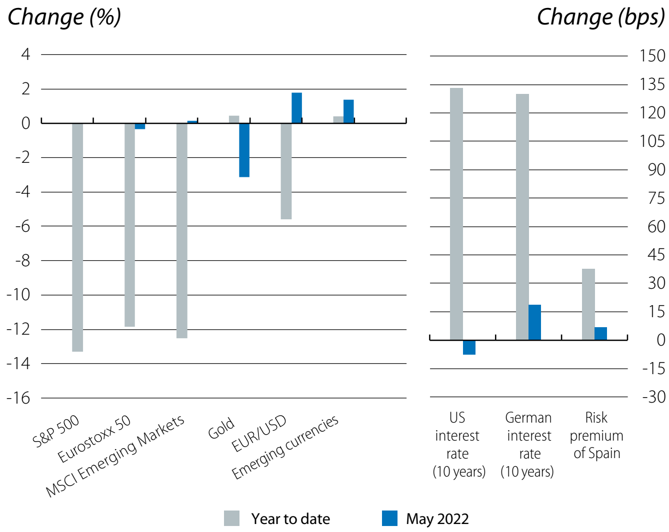
Survey: what do you consider to be the main tail risk in the financial markets?

(% of total respondents)



Note: *Survey conducted among 288 asset managers in different countries during the first few weeks of the corresponding months.*
Source: *Bank of America Global Fund Manager Survey.*

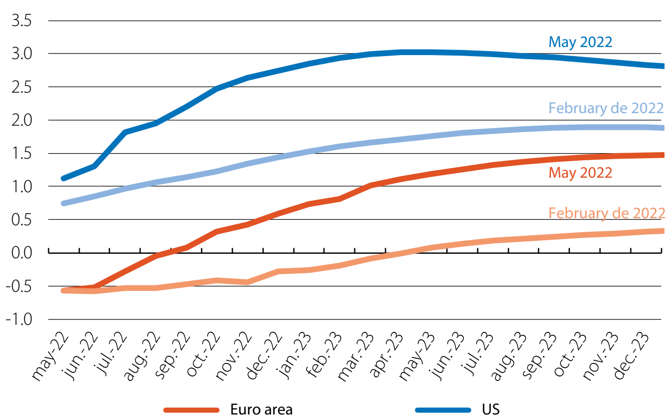
Select financial variables



Source: *BPI Research, based on data from Bloomberg.*

Expectations for ECB and Fed reference interest rates

(%)



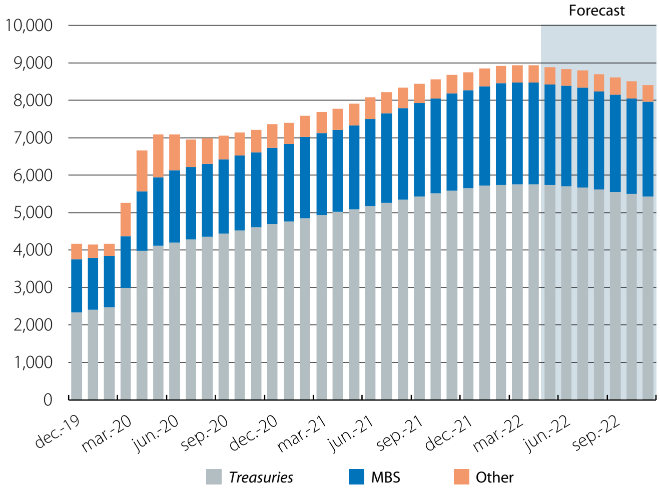
Nota: *Forwards on the EFFR and the OIS of the euro area derived using market yield curves.*
Source: *BPI Research, based on data from Bloomberg.*

anticipated May meeting, the US Federal Reserve raised interest rates by 50 bps, bringing them to the 0.75%-1.00% range, and announced that it intends to bring rates to more normal levels soon by implementing similar hikes at the next two meetings (June and July), according to its chair Jerome Powell. The Fed will also begin reducing the size of its balance sheet from June onwards, at a faster pace than in the previous cycle (see the Focus «On the reduction of the central banks' balance sheets» in this same report for more details). According to Powell, the US economy is well positioned to withstand a more restrictive monetary policy without necessarily triggering a recession, although this scenario has been questioned among investors. In other countries, the Bank of England and the central banks in Australia and New Zealand agreed to raise their official rates at their May meetings. The exception remains the Bank of Japan, which has kept its accommodative policy intact, leaving the yen fluctuating at close to its lowest values of the last two decades.

Emerging markets: the beginning of the storm? The heightened uncertainty surrounding the war in Ukraine, the tightening of financial conditions in the West, the escalating global inflationary pressures and the new COVID outbreaks in some regions continued to undermine investor interest in emerging countries. Thus, according to the International Finance Institute, in April there was a further decline in net portfolio flows to these economies (–4 billion dollars), adding to the 7.8-billion-dollar decline of the previous month. There is also some rotation in favour of commodity-exporting regions. In response, some countries' central banks approved further official rate hikes, particularly in Asia. The exceptions were the central banks of Russia and China (PBoC). The former announced a 300-bp cut in the benchmark rate, bringing it to 11%, while the latter agreed a reduction in the rate for five-year loans, which serves as a benchmark for mortgage lending. The collapse in China's economic data and the accommodative tone of the PBoC were reflected in a further weakening of the yuan against the major currencies.

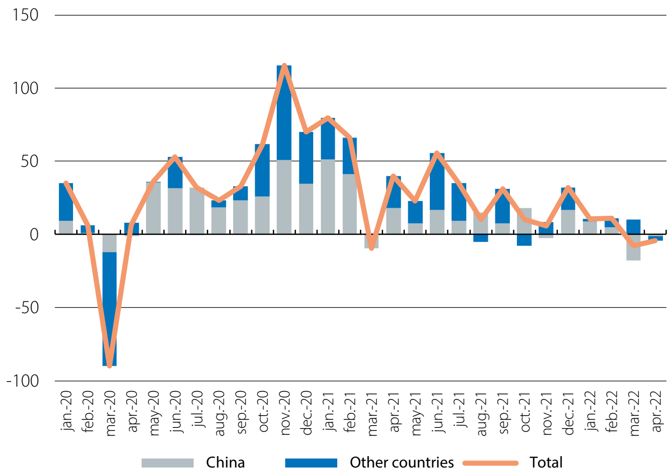
No respite in the commodity market tensions. Although highly volatile, energy prices continued to climb during the course of the month, primarily driven by uncertainty surrounding the ongoing conflict in Ukraine and the tightening of the sanctions imposed on Russia – factors which more than offset investor doubts about the evolution of the global economy. In this context, the higher demand from Europe, in its quest to replace supplies from Russia, helped to narrow the gap in the benchmark energy prices between the US (Henry Hub for gas and WTI for oil) and Europe (Dutch TTF and Brent). On the other hand, food prices remained high, with cumulative year-to-date increases of 49% for wheat and of 30% for corn. In contrast, the lower demand from China was reflected in a reduction in industrial metal prices.

Federal Reserve: total assets
(USD billions)



Source: *BPI Research, based on data from the Federal Reserve.*

Net capital flows to emerging economies
(USD billions)



Source: *BPI Research, based on data from Bloomberg.*

Commodities

	Measure	Price	Change (%)	
			Last month	In the year
Commodities	Index	132.1	2.0	33.2
Energy	Index	57.4	10.9	85.9
Brent oil	$/barrel	114.0	4.3	46.6
Natural gas (Europe)	€/MWh	88.1	–11.4	25.2
Precious metals	Index	216.5	–3.9	–1.2
Gold	$/ounce	1,853.5	–2.3	1.3
Palladium	$/ounce	2,009.1	–13.7	5.5
Industrial metals	Index	182.5	–8.1	5.5
Aluminium	$/mt	2,874.0	–5.8	2.4
Nickel	$/mt	26,788.0	–15.7	29.1
Agricultural	Index	76.7	–0.3	26.2
Soya	$/bushel	1,681.0	–1.6	26.5
Wheat	$/bushel	1,148.3	10.0	49.0

Note: *Data as of the period end.*
Source: *BPI Research, based on data from Bloomberg.*

On the reduction of the central banks' balance sheets

In the face of the intensification of inflationary pressures in recent months, the central banks have responded by bringing forward their monetary stimulus withdrawal strategies, first by ending net asset purchases and, more recently in most cases, by raising official rates. In this article, we focus on the next step in this monetary policy normalisation process: reducing the size of their balance sheets, or quantitative tightening (QT), as it is known.

QT is a restrictive monetary policy measure whereby central banks place back into the markets the financial assets that they acquired under their purchasing programmes during the monetary expansion phase (bonds, securities and, in some cases, equities).

At the operational level, central banks can execute QT by not reinvesting the bonds in their portfolio that mature, or, if they want to accelerate the reduction of their balance sheet, they can sell the assets they hold back to the markets at a pre-determined monthly rate. To date, only the Fed has carried out a QT process, specifically in the period 2017-2019.

The Fed announces an aggressive QT in 2022

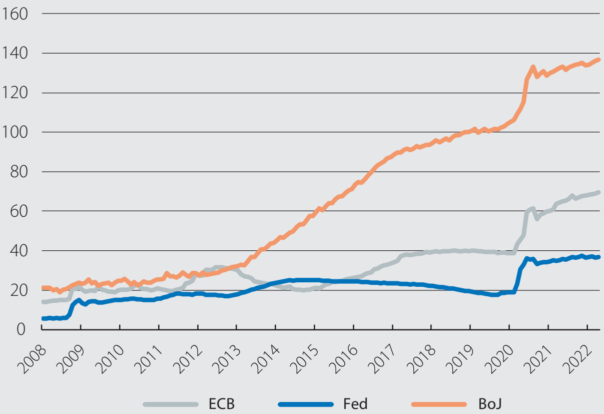
With total assets of 8.9 trillion dollars at the end of April, representing 37% of US GDP, at its May meeting the Fed confirmed its strategy to reduce the size of its balance sheet.

The plan sets a maximum pace for the balance sheet reduction of 47.5 billion dollars per month, through maturities of 30 billion dollars in Treasury bonds and the remainder in maturities of mortgage-backed securities (MBS). Beginning in September, the Fed plans to raise this cap to 95 billion dollars per month (60 billion in Treasuries and 35 billion in MBS).

The announcement of this QT has come much earlier in the monetary normalisation process than in the previous cycle, when the Fed waited two years after the first official rate hike (December 2015) before initiating QT (autumn 2017). Also, the pace of the reduction is much more aggressive this time: in 2017, the Fed set a monthly cap of 50 billion dollars, although in practice the initial pace was closer to 10 billion.

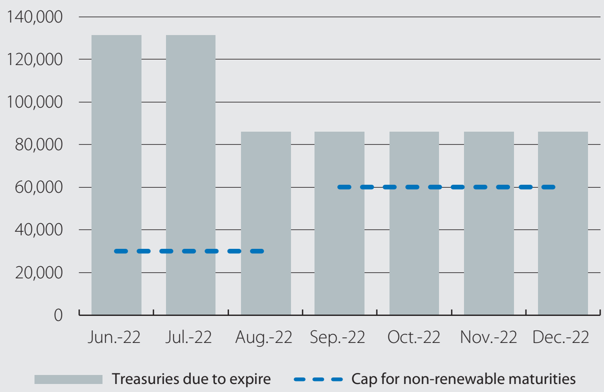
With regard to government bonds, the Fed recently stated that in the months when maturities fall below the cap, it will make up for the difference by shrinking its portfolio of Treasury notes. However, at least during 2022, Treasury bond maturities will exceed the limit every month, implying not only that the Fed will not actively sell notes, but also that it will have to reinvest some of the assets at maturity (see second chart). As for the MBS portfolio, it is highly likely that the limit set for its reduction will not be initially reached, as most of the maturities are more than a year away.

Central banks: total assets
(% of GDP)



Source: *BPI Research, based on data from Bloomberg.*

Fed: Treasury maturities in 2022
(USD billions)



Note: *Based on information available up to 27 April.*
Source: *BPI Research, based on data from the Federal Reserve.*

How does QT impact the financial markets?

Given the unusual nature of this policy, there is no consensus on the potential impact that QT could have on financial markets and on the real economy.

In practical terms, QT means less liquidity in the financial system, due to a reduction in bank reserves held by the central bank, as it will be banks, among other financial institutions, that will increase the most their exposure to the assets that are sold off by the Fed. Thus, to the extent that a significant portion of the demand for these assets (that of the central bank) is reduced, their interest rate will rise, such that QT ends up operating in a similar way to other monetary-tightening measures.

According to Jerome Powell, the balance sheet reduction process announced by the Fed for this year (amounting to some 520 billion dollars, or 2.3% of GDP) would equate to an additional 25-bp rise in official rates. Taking this sensitivity as a benchmark, the QT process would thus be equivalent to an additional 50-bp increase in official rates next year.[1]

With regard to the impact on the financial markets, the QT process would first exert upward pressure on the yields of the affected assets, namely government and private bonds, which would see their prices fall (and their interest rates increase) in the face of the higher net supply. This impact tends to be most pronounced in the middle and long end of the curve, as the central bank tends to concentrate bond purchases in that section of the curve. This increase in the reference rates would usually have a negative impact on equities and corporate spreads, while strengthening the dollar (see what happened following the QT announcement in 2017 in the last chart). However, the scale and persistence of this impact are difficult to quantify, given the wide range of factors built into financial asset prices.

In the current cycle, the QT announcement has intensified the recent rise in sovereign debt yields,[2] as well as increasing volatility in equity markets. On the other hand, the dollar has been further strengthened, appreciating 7% against the euro since the beginning of the year. We believe that some of the impact of the QT on the markets is likely to have already occurred, as the Fed had announced the broad outlines of the plan already back in January. Nevertheless, we do not rule out the possibility of new episodes of volatility, once the QT materialises beginning in June.

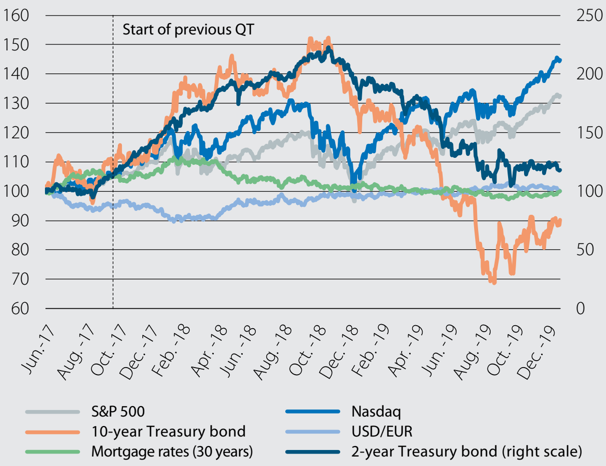
How does the Fed compare with other central banks?

The balance sheet reduction process is not unique to the US, as other central banks are already engaged in this process. For instance, the Bank of England has been allowing assets to mature since February, and since May it has been actively selling part of its corporate bond portfolio, while it is also due to set out its plans for government bond sales in the summer. The central banks of Canada and Australia are also letting assets expire at maturity, while Sweden's Riksbank expects to begin this process in the coming months.

The situation at the ECB, in contrast, is somewhat different. According to its official communications,

US: financial assets

*Level (100 = 14 June 2017) *   Level (100 = 14 June 2017)*



Note: ** On that date it was formally announced how the quantitative tightening (QT) process would be carried out.*
Source: *BPI Research, based on data from Bloomberg.*

up until the end of 2024 the ECB will reinvest the assets of the PEPP at maturity and those of the APP for a prolonged period following the first rate hike (which implies that QT could occur approximately two years from now). The fact is that if the ECB were to disappear from the debt markets, the risk of financial fragmentation in the euro area would be by no means negligible. For this reason, in addition to continuing to reinvest assets at maturity for a few years to come, the ECB is likely to allow some flexibility in these reinvestments in order to ease any asymmetric financial tensions arising between the different economies.

1. According to Fed estimates, reducing the central bank's balance sheet by 2% of GDP is equivalent to a 20-bp increase in official rates (see https://www.federalreserve.gov/econres/notes/feds-notes/substitutability-of-monetary-policy-instruments-20190719.htm).
2. See the Focus «On the increase in sovereign debt yields» in the MR05/2022.

Interest rates (%)

	31-May	30-April	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Euro area					
ECB Refi	0.00	0.00	0	0.0	0.0
3-month Euribor	–0.34	–0.43	9	23.4	20.5
1-year Euribor	0.39	0.17	22	89.1	87.5
1-year government bonds (Germany)	0.05	–0.23	28	69.1	68.4
2-year government bonds (Germany)	0.50	0.26	24	112.3	116.6
10-year government bonds (Germany)	1.12	0.94	18	129.9	132.0
10-year government bonds (Spain)	2.23	1.97	25	166.0	177.1
10-year government bonds (Portugal)	2.26	2.02	24	179.4	181.0
US					
Fed funds (upper limit)	1.00	0.50	50	75.0	75.0
3-month Libor	1.61	1.33	28	140.2	147.7
12-month Libor	2.74	2.63	11	215.7	249.5
1-year government bonds	2.05	2.06	–1	167.4	201.5
2-year government bonds	2.56	2.71	–16	182.4	241.2
10-year government bonds	2.84	2.93	–9	133.4	125.7

Spreads corporate bonds (bps)

	31-May	30-April	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	88	90	–2	39.8	38.5
Itraxx Financials Senior	97	102	–5	42.3	39.8
Itraxx Subordinated Financials	184	197	–13	76.0	77.0

Exchange rates

	31-May	30-April	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
EUR/USD (dollars per euro)	1.073	1.055	1.8	–5.6	–12.1
EUR/JPY (yen per euro)	138.110	136.950	0.8	5.5	3.2
EUR/GBP (pounds per euro)	0.852	0.839	1.6	1.2	–1.2
USD/JPY (yen per dollar)	128.670	129.700	–0.8	11.8	17.4

Commodities

	31-May	30-April	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	629.5	643.3	–2.2	8.8	14.3
Brent ($/barrel)	122.8	109.3	12.3	57.9	72.2
Gold ($/ounce)	1,837.4	1,896.9	–3.1	0.4	–3.7

Equity

	31-May	30-April	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	4,132.2	4,131.9	0.0	–13.3	–1.8
Eurostoxx 50 (euro area)	3,789.2	3,802.9	–0.4	–11.8	–7.3
Ibex 35 (Spain)	8,851.5	8,584.2	3.1	1.6	–3.6
PSI 20 (Portugal)	6,257.5	5,930.0	5.5	12.4	21.3
Nikkei 225 (Japan)	27,279.8	26,847.9	1.6	–5.3	–5.8
MSCI Emerging	1,077.7	1,076.2	0.1	–12.5	–22.4

Inflation dictates the agenda of central banks around the world

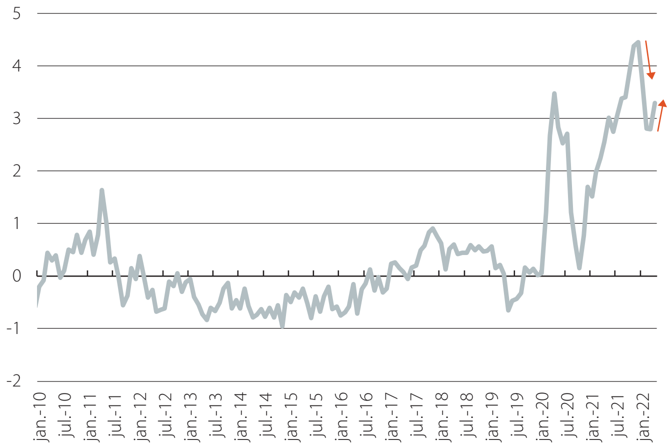
The war in Ukraine remains the key factor in the global scenario. Developments in the war in Ukraine and the persistence of China's zero-COVID policy remain the main factors determining the current scenario. Both events are further aggravating the problems in global supply chains, pushing up the price of key inputs for industry, as well as that of many industrial and agricultural commodities. As a result, inflation rates are at record highs in most developed and emerging economies, forcing central banks to take action to keep medium-term inflation expectations in check, despite the deterioration in economic activity and in the outlook in some cases. Only China, Russia, Japan and Turkey are not currently following this widespread monetary trend.

The ECB is ready to act. To date, it is the only central bank in the G7 (except Japan) that has not yet raised official interest rates, but in an entry on the ECB's blog, Lagarde made it clear that this could change at the July meeting. Some may question whether now is a good time to raise rates, given the growing uncertainty and the deteriorating growth outlook for the region. However, with inflation in May at 8.1% and with no signs that it has peaked yet, medium-term inflation expectations need to be kept under control, as the consequences of failing to act now could be more damaging in the future (see the Focus «Rate hikes in the euro area, under the microscope» in this same report).

The risks to euro area growth in the coming months increase. Confidence among economic agents collapsed in March, with the outbreak of the war in Ukraine, before stabilising in April and May at these low levels. The most pronounced deterioration is seen in industry, the sector hardest hit by the bottlenecks in global supply chains and by the sharp rise in production costs, as well as among households, which are very concerned about their loss of purchasing power due to rising inflation. Confidence in the services sector, meanwhile, seems to be holding up better for now, having benefited the most from the end of the COVID-related restrictions. On balance, after a moderately positive start to the year (euro area GDP grew by 0.2% quarter-on-quarter in Q1 2021), there is no guarantee that euro area GDP will maintain this good tone in Q2 2022. Moreover, there is an increase in the downside risks for the second half of the year: after Russia cut off its gas supplies to Poland, Bulgaria, Finland and the Netherlands, the threat that it could extend these cuts to the rest of Europe is more real than ever. Indeed, the European Commission has presented a series of alternative forecast scenarios in its spring economic outlook report: in one of them, it estimates that if Russia were to cut its gas supplies, then the euro area's average economic growth in 2022 would be virtually zero, and inflation could reach almost 9.0% on average for the year.

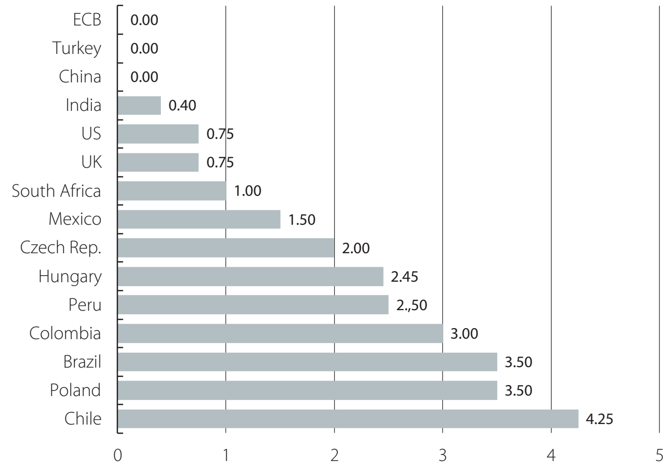
The weakness of US GDP in Q1 2022 will not alter the Fed's roadmap. It is true that the US economy performed worse than expected in Q1 2022, shrinking 0.4% quarter-on-quarter. However, the analysis by component paints a more nuanced picture: domestic demand remained buoyant thanks to the

Pressure on global supply chains
Index



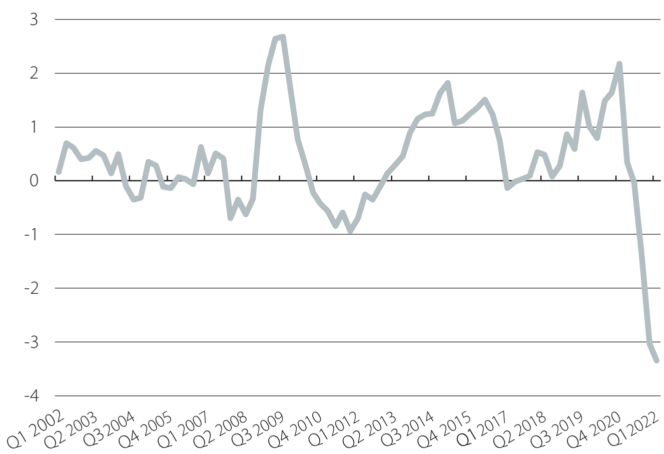
Note: *The average of the Global Supply Chain Pressure Index is zero.*
Source: *BPI Research, based on data from the New York Fed.*

*Global: interest rate hikes in 2022 **
(bps)



Note: ** Between January and May.*
Source: *BPI Research, based on data from Bloomberg.*

Euro area: inflation-deflated negotiated wages
Year-on-year change (%)



Source: *BPI Research, based on data from the ECB.*

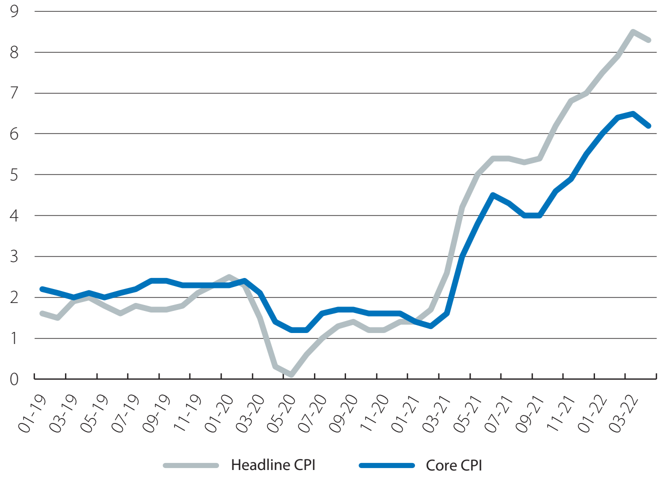
boost from private consumption and non-residential investment. Moreover, the labour market remains strong: in April, 428,000 new jobs were created, the unemployment rate remained stable at a low 3.6% and wages rose by 5.5% year-on-year. Against this backdrop of strong domestic demand, inflation fell in April after reaching a 40-year peak in the previous month, although it remains very high: headline inflation stands at 8.3% and core inflation at 6.2%. The coming months will see continued upward pressure on inflation due to the stress in the labour market, the effects of the war in Ukraine and closures in China due to its zero-COVID policy. Thus, although inflation will be declining, these factors will keep it high and prevent it from returning to the 2.0% benchmark until late 2023. This justifies the Fed's clearly hawkish tone, having stated its intention to raise interest rates above «neutral» levels if necessary. These more restrictive financial conditions, the lack of agreement on much of Biden's Build Back Better Plan and a weaker-than-expected start to the year lead us to cut our 2022 average growth forecast for the US by 0.75 pps, bringing it to 2.4%.

Uneven start to the year in the other two major G7 economies. On the one hand, the United Kingdom surprised analysts by registering an impressive growth of 0.8% quarter-on-quarter in Q1 2022 (8.7% year-on-year), placing economic activity 0.7% above pre-COVID levels. However, this apparent good result conceals a deterioration during the course of the quarter, and this trend will continue in Q2 2022, as anticipated by the Bank of England's May forecasts. On the other hand, Japan registered a contraction of 0.2% quarter-on-quarter in Q1 2022 (+0.2% year-on-year), as a result of the strict restrictions imposed to contain the new outbreaks of COVID-19. Thus, over the last year, the Japanese economy has failed to register two consecutive quarters with positive growth.

China's zero-COVID policy is having a clear impact on the country's economic activity, while the war in Ukraine is beginning to take its toll on the Russian economy. In China, GDP growth exceeded our expectations in Q1 2022 (4.8% year-on-year). However, by March and April most of the economic activity and foreign trade indicators were already showing a sharp slowdown, compatible with a fall in GDP in Q2 2022. To alleviate the impact of its zero-COVID policy, both the government and the central bank have implemented a series of economic stimulus measures, although we believe that they will not be enough. Indeed, the deterioration we envisage for Q2 leads us to reduce our growth forecast for 2022 by 1 pp, to 3.7%, well below the government's target of 5.5%. In Russia, meanwhile, year-on-year growth in Q1 2022 moderated to 3.5%, down from the 5.0% registered in Q4 2021. This is a significant slowdown due to the sharp decline in economic activity in March as a result of the war in Ukraine. The outlook for Russia has deteriorated substantially in the wake of the conflict, given that, regardless of how long the conflict lasts, the economy will be severely damaged by the Western sanctions and the flight of foreign investment (for instance, more than 300 multinationals have already ceased or limited their activity in the country). As a result, we anticipate that Russia's GDP in 2022 will fall by 8.0%, although the risks are clearly skewed to the downside.

US: CPI

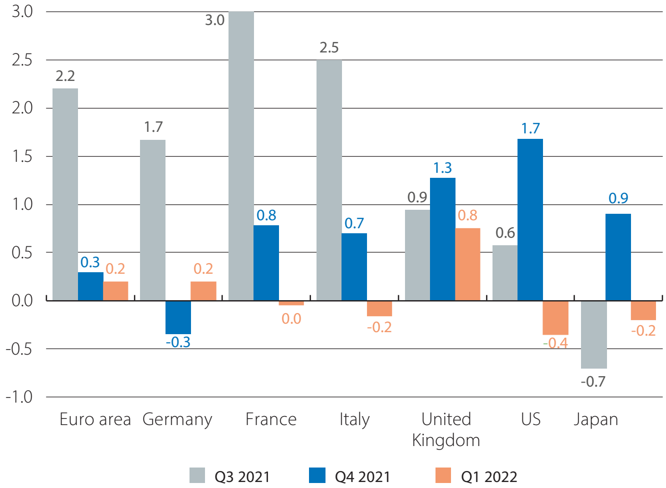
Year-on-year change (%)



Source: *BPI Research, based on data from the BLS.*

Global: GDP

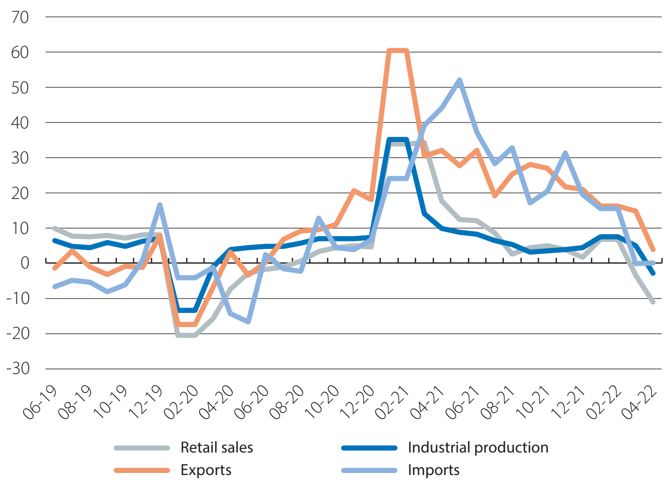
Quarter-on-quarter change (%)



Source: *BPI Research, based on data from Eurostat, the BEA and Bloomberg.*

China: economic activity indicators and foreign trade

Year-on-year change (%)



Source: *BPI Research, based on data from the National Statistics Office of China.*

Rate hikes in the euro area, under the microscope

Inflation in the euro area continues to be affected by the double impact of the war in Ukraine and the deterioration of the bottlenecks in China due to its zero-COVID policy. The persistence of these factors explains why inflation continues to break records (see first chart) and why the possibility of it climbing to even higher levels in the coming months cannot yet be ruled out. As a result, inflation expectations have been steadily rising in recent months; for example, since January, our forecast for euro area headline inflation in December 2022 has been revised up by nearly 5.0 pps, to around 6.0%.

At this juncture, there is increasing pressure on the ECB to start raising interest rates, something that has not happened since 2011. However, in the current context of an economic slowdown with a multitude of downside risks, is it desirable for the ECB to begin to normalise its monetary policy in the coming months? Would it be better to wait for economic growth to recover?

Benefits of raising interest rates

Economic theory tells us that raising rates slows growth in consumption and investment, thereby curbing the advance of domestic demand, helping to control inflationary pressures, as well as keeping inflation expectations well anchored – particularly important in the current context marked by a sharp rise in energy and other commodity prices.

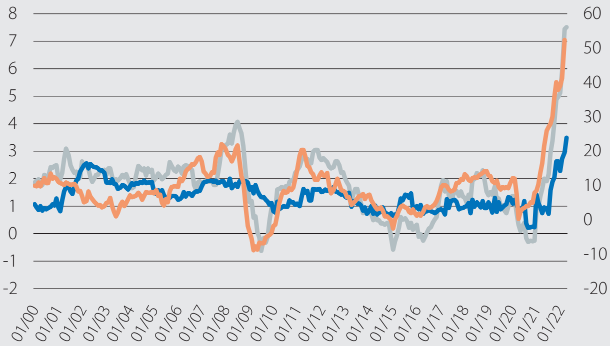
This anchoring of expectations is essential for preventing inflationary shocks like the current one from producing unwanted second-round effects that would intensify the rise in prices and make it chronic. In recent months we have witnessed a significant increase in inflation expectations, both in the financial markets (euro area swaps anticipate inflation of around 5% over the next two years) and among consumers and business leaders, with short- and medium-term expectations at record highs. Although these second-round effects are not yet materialising in Europe, it is a risk that should be taken into account.[1]

On the other hand, it should be noted that the easing of monetary conditions in the euro area is a process that has been going on for years: the outbreak of the financial crisis in 2008 forced policymakers to introduce major monetary stimulus to alleviate its effects, which even needed to be reinforced to prevent the sovereign debt crisis of 2010 from triggering a breakup of the euro area. In fact, the monetary conditions index developed by the European Commission[2] suggests that monetary policy conditions are currently the most accommodative they have been since the euro was created (see second chart), and this increases the risk of bubbles forming in certain financial markets.[3]

In this regard, a recent report by the European Securities and Market Authority (ESMA)[4] echoes developments in the real estate sector in the euro area since the start of the pandemic: home prices have risen by around 16%,

Euro area: HICP and price expectations

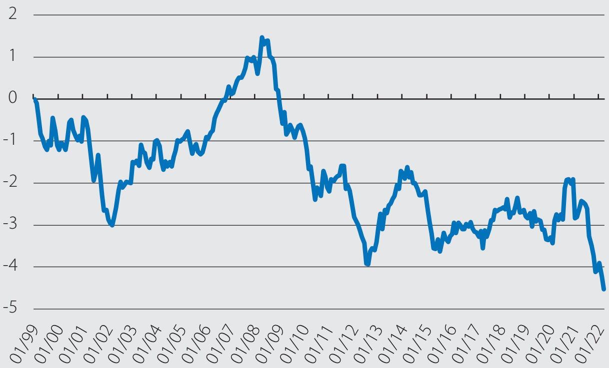
Year-on-year change (%) *Aggregate balance of responses*



Note: *The series reflecting the aggregate balance of responses is calculated using the price expectations of consumers and of the manufacturing, services and retail sectors published by the European Commission, which reflect the difference between the percentage of respondents who expect the final prices to be higher and the percentage that expects them to be lower.*
Source: *BPI Research, based on data from Eurostat and the European Commission.*

Euro area: monetary conditions index

Index (0 = January 1999)



Note: *Positive and negative values show tight and accommodative monetary conditions, respectively.*
Source: *BPI Research, based on data from the European Commission.*

1. See the Dossier «The response of wages to the rise in inflation» in the MR05/2022.

2. This index is calculated as a weighted average of the short-term real interest rate and the actual effective exchange rate relative to its value in a baseline period.
3. Let us recall the consequences of the dot-com bubble in the early 2000s and the subprime mortgage bubble in 2008, which dragged the global economy into the so-called Great Recession.
4. See «Joint Committee Report on Risk and Vulnerabilities in the EU Financial System». March 2022.

with widely varying patterns from country to country. ESMA is also concerned about the consequences of the rapid expansion of the cryptocurrency market. This concern makes sense if we consider that since the market capitalisation peaked at over 3.2 trillion dollars in November last year, the cryptocurrency market has already suffered a 60% correction.

Costs of raising interest rates

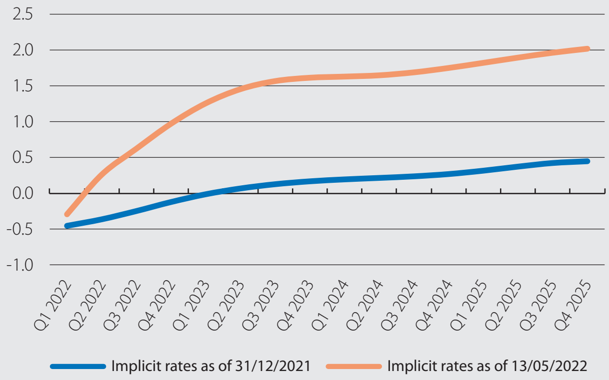
We have already pointed out that, according to economic theory, raising rates has a negative impact on domestic demand. In order to assess the potential impact of this shift in interest rate expectations in recent months, we took the difference between the implicit rate curve for the 12-month Euribor as it stood at 13 May 2022 and at 31 December 2021 – before the surge in market expectations – and we introduced it into CaixaBank Research's model for the euro area (see third chart).[5] If the higher interest rates anticipated by the market were to come to fruition, then euro area growth could be cut by 0.2 pps in 2022, by 0.7 pps in 2023, by 0.5 pps in 2024 and by 0.2 pps in 2025 compared to our baseline scenario (see fourth chart). By component, the impact on consumption would be similar to that of GDP, while investment would be the component most affected, as its growth could be cut by 1.1 pps in 2023 and 2024, and by 0.5 pps in 2025 compared to the baseline scenario. The impact on job creation, meanwhile, would be significantly lower, at around 0.2 pps less than in the baseline scenario on average over the next three years.[6, 7]

Conclusion

The ECB is facing the dilemma of raising interest rates, at the cost of cooling domestic demand, at a time when the tightening of bottlenecks and, above all, the fallout from the war in Ukraine are already taking a toll on economic activity in the euro area. It should be noted that, based on current market expectations, the cost in terms of economic growth of normalising interest rates is moderate and growth rates above 2.0% are still feasible this year and next.[8] Furthermore, beginning to raise rates would help contain medium-term inflation expectations and reduce the risk of bubbles. This appears to be the ECB's reading of the situation, and all signs point to the fact that it will begin to gradually raise interest rates over the coming months.[9] Indeed, failing to act now could mean having to raise them much more in the future.

Euro area: 12-month Euribor

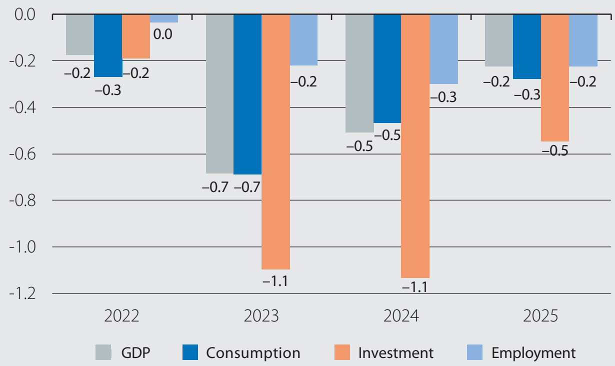
(%)



Note: *In the series of implicit rates as of 13 May 2022, the data up to April correspond to the historical 12-month Euribor.*
Source: *BPI Research, based on data from Bloomberg.*

Euro area: macroeconomic response to rising interest rates

Impact on annual growth (pps)



Note: *The GDP, consumption and investment series are shown in real terms.*
Source: *BPI Research, based on the Working Paper «Modelo semiestructural de CaixaBank Research para la eurozona» of 02/21 (content available in Spanish).*

5. This is a general equilibrium model which is determined by aggregate demand in the short-term, while in the long-term aggregate supply and demand are equal. For further details, see E. Llorens (2021). «Modelo semiestructural de CaixaBank Research para la eurozona». CaixaBank Research Working Paper 02/21 (content available in Spanish).
6. The response of the different variables to a standard monetary shock (an impact of 100 bps) in our model is very similar to that found in the benchmark models. For more details on the latter, see F. Smets and R. Wouters (2002) «An estimated dynamic stochastic general equilibrium model of the euro area» and E. Angelini *et al.* (2019) «Introducing ECB-BASE: The blueprint of the new ECB semi-structural model for the euro area». European Central Bank Working Paper Series.
7. Beyond the impact on the real economy, rate hikes also exert upward pressure on sovereign bond yields, i.e. the interest which countries pay for issuing debt. However, debt yields and risk premia are still fairly low in historical terms. Moreover, the ECB has already pointed out that once its net asset purchases have ceased, it could take a flexible approach to managing the reinvestments of the assets that mature and could even design new instruments to ensure that monetary policy is transmitted correctly. This is reassuring news for countries with high debt ratios.
8. We are assuming a scenario in which the war in Ukraine does not spread geographically and in which Russia does not completely cut its gas supplies to the euro area.
9. In an entry in the ECB's blog (on 23 May), Christine Lagarde stated that she expects net purchases under the APP to end very early in Q3. This would allow for a first interest rate hike in July and would open the door for rates to emerge from negative territory by the end of Q3.

Year-on-year (%) change, unless otherwise specified

UNITED STATES

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	02/22	03/22	04/22
Activity									
Real GDP	–3.4	5.7	12.2	4.9	5.5	3.5	–	–	–
Retail sales (excluding cars and petrol)	2.1	17.5	27.4	14.3	16.2	11.3	15.8	6.6	8.2
Consumer confidence *(value)*	101.0	112.7	122.1	116.7	112.9	108.1	105.7	107.6	107.3
Industrial production	–7.2	5.5	14.7	5.5	4.4	5.3	7.5	5.4	6.4
Manufacturing activity index (ISM) *(value)*	52.5	60.6	61.0	60.0	60.1	57.8	58.6	57.1	55.4
Housing starts *(thousands)*	1,396	1,605	1,591	1,569	1,679	1,724	1,777	1,728	1,724
Case-Shiller home price index *(value)*	228	267	262	274	283	...	299	...	...
Unemployment rate *(% lab. force)*	8.1	5.4	5.9	5.1	4.2	3.8	3.8	3.6	3.6
Employment-population ratio *(% pop. > 16 years)*	56.8	58.4	58.0	58.6	59.2	59.9	59.9	60.1	60.0
Trade balance [1] *(% GDP)*	–3.2	–3.7	–3.6	–3.7	–3.7	–4.0	–3.8	–4.0	...
Prices									
Headline inflation	1.2	4.7	4.8	5.3	6.7	8.0	7.9	8.5	8.3
Core inflation	1.7	3.6	3.7	4.1	5.0	6.3	6.4	6.5	6.2

JAPAN

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	02/22	03/22	04/22
Activity									
Real GDP	–4.6	1.7	7.4	1.2	0.4	0.2	–	–	–
Consumer confidence *(value)*	31.0	36.3	36.1	37.5	38.3	34.8	35.2	32.8	33.0
Industrial production	–10.6	5.6	18.4	6.6	1.1	–0.6	0.5	–0.8	...
Business activity index (Tankan) *(value)*	–19.8	13.8	14.0	18.0	18.0	14.0	–	–	–
Unemployment rate *(% lab. force)*	2.8	2.8	2.9	2.8	2.7	2.7	2.7	2.6	...
Trade balance [1] *(% GDP)*	0.1	–0.3	0.6	0.3	–0.3	–1.0	–0.7	–1.0	–1.7
Prices									
Headline inflation	0.0	–0.2	–0.7	–0.2	0.5	0.9	0.9	1.2	2.4
Core inflation	0.2	–0.5	–0.9	–0.5	–0.7	–0.9	–0.9	–0.7	0.8

CHINA

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	02/22	03/22	04/22
Activity									
Real GDP	2.2	8.1	7.9	4.9	4.0	4.8	–	–	–
Retail sales	–2.9	12.4	14.1	5.1	3.5	1.6	6.7	–3.5	–11.1
Industrial production	3.4	9.3	9.0	4.9	3.9	6.3	7.5	5.0	–2.9
PMI manufacturing *(value)*	49.9	50.5	51.0	50.0	49.9	49.9	50.2	49.5	47.4
Foreign sector									
Trade balance [1,2]	524	681	605	636	681	734	698	734	744
Exports	3.6	30.0	30.7	24.4	23.1	15.7	6.2	14.6	3.8
Imports	–0.6	30.1	44.1	25.4	23.6	9.8	10.6	0.0	0.0
Prices									
Headline inflation	2.5	0.9	1.1	0.8	1.8	1.1	0.9	1.5	2.1
Official interest rate [3]	3.9	3.8	3.9	3.9	3.8	3.7	3.7	3.7	3.7
Renminbi per dollar	6.9	6.5	6.5	6.5	6.4	6.3	6.3	6.3	6.4

Notes: *1. Cumulative figure over last 12 months. 2. Billion dollars. 3. End of period.*
Source: *BPI Research, based on data from the Department of Economic Analysis, Bureau of Labor Statistics, Federal Reserve, Standard & Poor's, ISM, National Bureau of Statistics of Japan, Bank of Japan, National Bureau of Statistics of China and Refinitiv.*

EURO AREA

Activity and employment indicators

Values, unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	02/22	03/22	04/22
Retail sales *(year-on-year change)*	–0.8	5.5	12.7	2.5	4.2	4.8	5.2	0.8	...
Industrial production *(year-on-year change)*	–7.9	8.8	24.4	6.0	0.2	–0.2	1.7	–0.8	...
Consumer confidence	–14.2	–7.4	–5.6	–4.2	–7.6	–13.6	–9.5	–21.5	–22.0
Economic sentiment	88.3	110.8	111.0	117.3	115.7	111.2	114.2	106.5	104.9
Manufacturing PMI	48.6	60.2	63.1	60.9	58.2	57.8	58.2	56.5	55.5
Services PMI	42.5	53.6	54.7	58.4	54.5	54.1	55.5	55.6	57.7
Labour market									
Employment (people) *(year-on-year change)*	–1.5	1.1	2.0	2.1	2.1	...	...	–	–
Unemployment rate *(% labour force)*	8.0	7.7	8.1	7.5	7.1	6.9	6.9	6.8	...
Germany *(% labour force)*	3.9	3.6	3.7	3.5	3.2	3.0	3.0	2.9	...
France *(% labour force)*	8.0	7.9	8.2	7.8	7.5	7.4	7.4	7.4	...
Italy *(% labour force)*	9.3	9.5	9.8	9.1	9.0	8.5	8.5	8.3	...
Real GDP *(year-on-year change)*	–6.5	5.6	14.6	4.1	4.7	5.1	5.1	–	–
Germany *(year-on-year change)*	–4.9	3.1	10.4	2.9	1.8	3.8	3.8	–	–
France *(year-on-year change)*	–7.9	7.2	19.2	3.0	4.9	4.5	4.5	–	–
Italy *(year-on-year change)*	–9.1	7.0	17.5	4.0	6.4	6.2	6.2	–	–

Prices

Year-on-year change (%), unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	02/22	03/22	04/22
General	0.3	2.6	1.8	2.8	4.6	6.1	5.9	7.4	7.4
Core	0.7	1.5	0.9	1.4	2.4	2.7	2.7	3.0	3.5

Foreign sector

Cumulative balance over the last 12 months as % of GDP of the last 4 quarters, unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	02/22	03/22	04/22
Current balance	2.1	2.6	3.2	3.2	2.6	2.0	2.3	2.0	...
Germany	7.1	7.4	8.1	7.9	7.4	6.7	7.2	6.7	...
France	–1.9	–0.6	–1.2	–0.7	–0.6	–0.7	–0.6	–0.7	...
Italy	3.8	2.4	4.1	3.6	2.4	1.5	1.8	1.5	...
Nominal effective exchange rate [1] *(value)*	**93.9**	**94.2**	**94.9**	**94.0**	**92.7**	**92.6**	**92.7**	**92.9**	**91.0**

Credit and deposits of non-financial sectors

Year-on-year change (%), unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	02/22	03/22	04/22
Private sector financing									
Credit to non-financial firms [2]	6.3	3.5	2.3	1.8	3.3	4.4	4.6	4.1	5.2
Credit to households [2,3]	3.2	3.8	3.9	4.1	4.1	4.4	4.4	4.5	4.5
Interest rate on loans to non-financial firms [4] *(%)*	1.2	1.2	1.2	1.3	1.1	1.2	1.1	1.2	...
Interest rate on loans to households for house purchases [5] *(%)*	1.4	1.3	1.3	1.3	1.3	1.4	1.4	1.4	...
Deposits									
On demand deposits	12.9	12.6	12.4	11.4	10.5	9.2	9.3	8.7	8.2
Other short-term deposits	0.6	–0.8	–0.6	–2.0	–1.5	–0.3	–0.3	–0.3	0.4
Marketable instruments	8.1	11.4	12.2	10.2	9.2	0.0	–1.3	0.3	–0.4
Interest rate on deposits up to 1 year from households *(%)*	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	...

Notes: *1. Weighted by flow of foreign trade. Higher figures indicate the currency has appreciated. 2. Data adjusted for sales and securitization. 3. Including NPISH. 4. Loans of more than one million euros with a floating rate and an initial rate fixation period of up to one year. 5. Loans with a floating rate and an initial rate fixation period of up to one year.*
Source: *BPI Research, based on data from the Eurostat, European Central Bank, European Commission, national statistics institutes and Markit.*

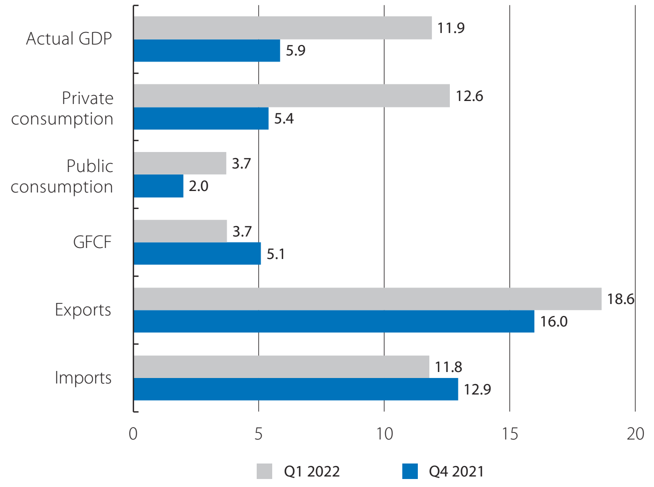
Portugal: good start pushes domestic annual growth up 6%

Upward revision of growth in 2022 due to inclusion of good Q1 results. The INE confirmed that the economy grew by 2.6% quarter-on-quarter and 11.9% year-on-year in Q1, driven by consumption and the recovery of tourism. So, if growth were to stagnate for the rest of the year, the economy would grow by 6.3% in 2022. However, signs suggest that economic activity will continue to expand, albeit at a slower pace than in Q1, so we have revised our forecast for actual GDP growth in 2022 to 6.6% (previously, 4.2%). The risks are reasonably balanced, as they include the impact of limiting factors, such as continuing bottlenecks in production chains (which means that higher prices will remain for some products), higher inflation for longer and the increase in interest rates. Activity indicators for Q2 suggest that the economy will continue to expand, but that it has entered a downward phase. The daily activity indicator suggests that activity grew by more than 7% year-on-year in April and May, with a softening trend (2.8% in the first 22 days of May); however, the reading cannot be direct, given the different degrees of confinement in the compared months. Nonetheless, the deceleration trend is confirmed by the behaviour of sentiment indicators, which decreased in practically all sectors in May. The biggest concerns in all sectors except for services stem from the pace of demand and rising prices. Confidence practically stabilised in this sector, despite the strong improvement in the accommodation and catering sector.

Inflation rises again in May, to 8%. It was in this context that last month BPI Research revised the forecast for average annual inflation upwards from 5.4% to 6% in 2022. It was clear that almost half of the IPC market basket had very high inflation (above 5%). In fact, in April 37 market basket groups had rates of more than 5% (32 in March), which is almost double the figure recorded in January (19). The core component of inflation also rose by 5.6% year-on-year in May, which signals that inflation may remain for a while longer. The context continues to be rather uncertain: firstly, the announcement of a new package of sanctions with an almost total embargo on Russian oil puts pressure on the price of crude; and secondly, at the time of writing, it has yet to be confirmed whether a maritime corridor will be opened to transport cereals from Ukraine's ports via the Black Sea, which could have a calming effect on these *commodities*.

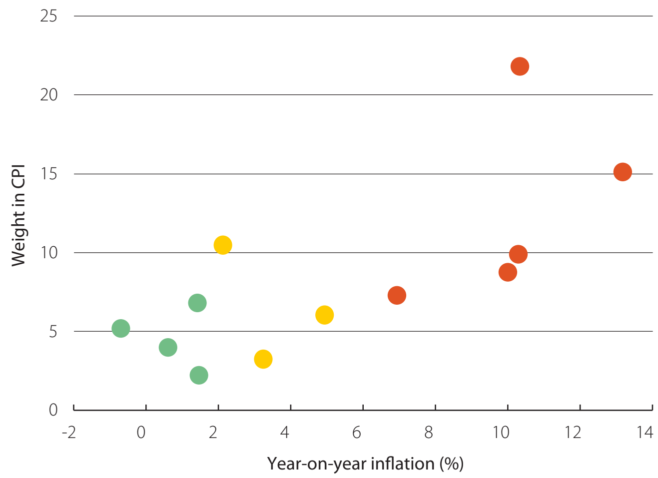
The job market remains buoyant despite the war. Employment continues to recover robustly (0.4% quarter-on-quarter and 4.7% year-on-year in Q1), surpassing by some distance the figures recorded before the pandemic (2.4% and 115,000 more jobs than in Q4 2019). The employment recovery in the post-pandemic period is due to an increase of 73,000 jobs in the private sector (+1.8%) and 42,000 more jobs in the public sector (+6.1%). More specifically, the public sector now employs a total of 741,288 individuals, the highest level witnessed since the end of 2011 (which is when regular data on

Portugal: GDP - demand elements
Year-on-year change (%)



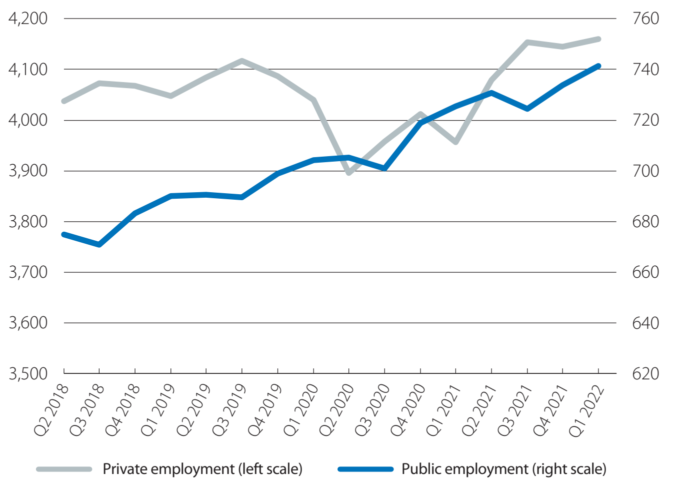
Source: *BPI Research, based on data from Datastream.*

CPI April 2022: view by expense classes



Source: *BPI Research, based on data from the INE.*

Portugal: Public and private sector employment
(Thousand Individuals) *(Thousand Individuals)*



Source: *BPI Research based on data from the National Institute of Statistics and the Directorate-General for Public Administration and Employment.*

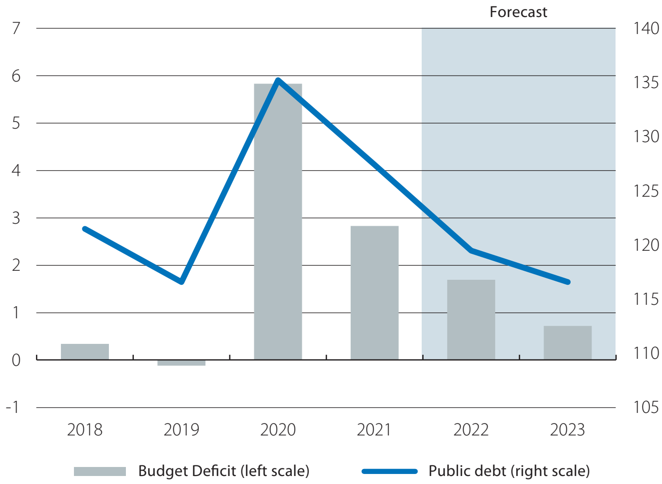
public employment became available). This represents 15.1% of the entire employed workforce. With a more positive than expected Q1 (the unemployment rate dropped to 5.9%, versus our forecast of 6.4%) and a moderate outlook for economic activity, we forecast that the unemployment rate will to fall to 5.9% for the year as a whole (previously 6.7%). This scenario is not without risks, which basically relate to what effects the war and higher interest rates will have on the economy.

The return of fiscal consolidation on the back of a normalised economy. In the first four months of the year, the budget deficit reached 1.0% of GDP, which is significantly below the figure for the same period in the previous year (-7.2%) and the figure for 2019 (-1.8%). This improvement compared to 2021 is due to substantial growth in revenue (+15% year-on-year), specifically in tax revenue (especially VAT), and the fall in expenditure (-1.8% year-on-year). This is due to the reduction in interest charges and current transfers, which in this case are caused by the reduced impact of the COVID measures to support companies and families. After the surprising budget deficit in 2021 (-2.8% of GDP, compared to the forecast -4.3%), and considering the State Budget for 2022 presented in April, we recently revised our forecast for the budget balance downwards to –1.7% of GDP in 2022 (previously –2.1% in government accounts). Likewise, the public debt ratio is expected to fall to 119.5% of GDP (127.4% in 2021), reaching the pre-pandemic level next year (116.6%). Risks for this scenario relate mainly to economic activity and the increase in inflexible expenditure (see public employment evolution).

Exuberant tourist sector in April. The number of guests and overnight stays was 1.6% and 1.1% higher, respectively, compared to the same period prior to the pandemic for the first time since the start of COVID-19. Q1 2022 closed down -19% in terms of the number of guests and overnight stays compared to the same quarter in 2019, but this latest data suggests very positive prospects for the strongest months for Portuguese tourism. Meanwhile, the latest data from the *European Travel Commission* (which was published after the start of the war in Ukraine) indicate that more than 80% of people from important outbound markets (Spain, Germany and the United Kingdom, for example) intend to go on holiday in 2022. Inflationary pressures, the price of *jet fuel* and the lack of staff reported by some hotel chains remain the main risks on the horizon.

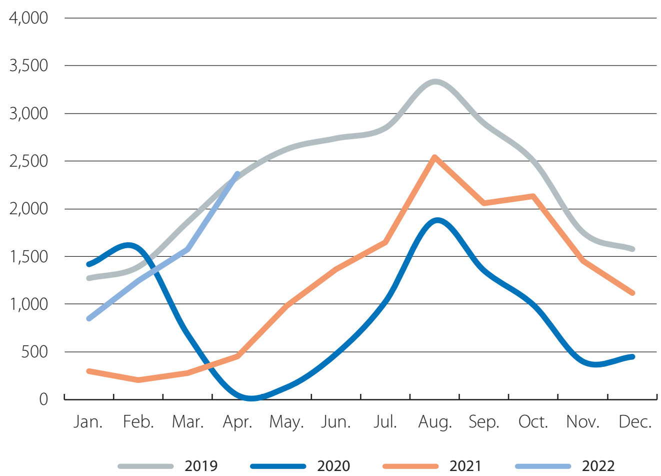
Upward revision of the forecast for residential property prices. Although the INE home price index for Q1 2022 has not yet been released at the time of writing, we have revised our forecast for 2022 property prices upwards (from 7.1% to 7.7%). The available data point in this direction: Confidencial Imobiliário's Residential Price Index increased 17% year-on-year in Q1 and continued to rise in April (17.5%); the bank assessment data on mortgage loans in April also increased to 13% year-on-year (resulting in a median value of Euros 1,356 m2). Despite the fact that agents in this market are more confident than they were before the pandemic, we think the second half of the year will be more moderate due to inflationary pressures on family budgets and rising benchmark interest rates.

Portugal: budget deficit and public debt
(% GDP) *(% GDP)*



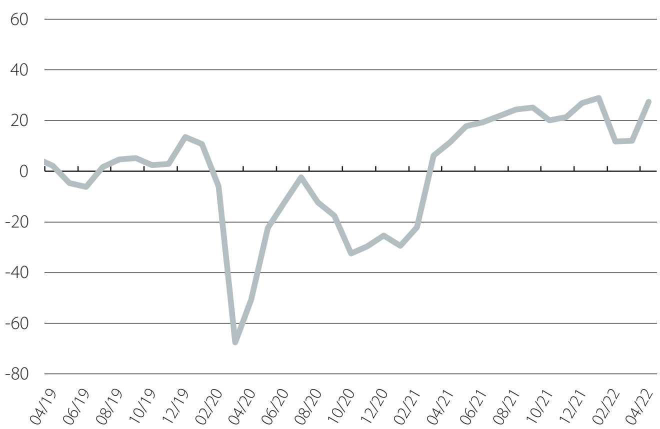
Source: *BPI Research, based on data from the National Institute of Statistics.*

Portugal: number of guests
(Thousands)



Source: *BPI Research, based on data from the National Institute of Statistics.*

Property market confidence index
Points



Source: *BPI Research, based on data from Confidencial Imobiliário. The confidence index is an average of the net balance of responses about prices and sales.*

High inflation: an uneven burden?

Since 2013, average annual inflation in the Euro area has been below 2%, and therefore compatible with the ECB's mandate to maintain price stability. After several years on the sidelines, inflation has now returned to dominate headlines and make the news due to successive increases and the expected consequences for monetary policy. As of July 2021, monthly inflation measured in year-on-year terms has been exceeding 2% and has continued to grow until it reached 7.5% last April. Although initially at a much more moderate pace, Portugal followed the trend and in April inflation measured by the CPI recorded a year-on-year value of 7.2%, the highest since March 1993. It is also worth noting that there is a greater proximity between global inflation and underlying inflation than there is in the Euro area, which indicates that the energy component has affected other areas more quickly.

In January 2021 only 19% of the categories in the price basket registered price increases of more than 2%; in April of this year this value increased to 71% of the basket, and 47% of the categories are even above 5%. Inflation in the Food Products component, which in January of last year stood at 1%, reached a significant 10.25% last April. The rises in essential goods and services are important as demand for products in these sectors is less flexible, meaning that the percentage change in price reflects a lower percentage change in the quantity required of the good or service at issue. Put in simpler terms: we can delay purchasing durable goods, take fewer holidays abroad or not go to an event; but it is difficult to reduce or postpone consuming food or heating our home.

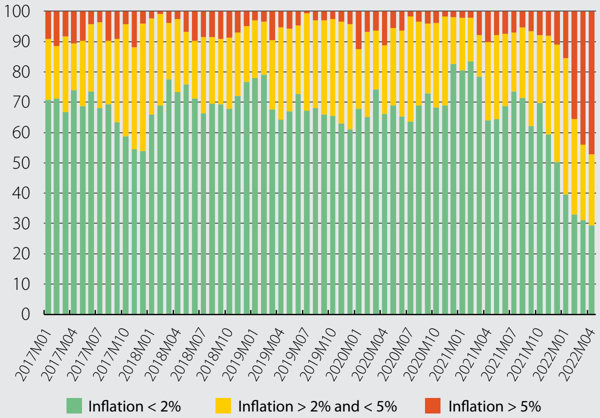
The spread of high inflation throughout the basket makes it increasingly difficult to remain «immune» to price rises; however, the weight of the different categories in the consumer basket on household budgets will vary depending on the type of consumer and their income level. Eurostat[1] data shows that in Portugal, families with the lowest incomes (1st quintile) allocate 18.3% of their expenditure to food products, while families with higher incomes (5th quintile) allocate only 11.6%. This empirical confirmation of the «old» Engel's Law also applies to other essential goods and services such as housing, water, electricity, gas and other fuels. Under this Law, lower income families allocate 39.1% of their expenditure to essential goods and services, while higher income families allocate just 28.2%.

Naturally, different consumption patterns will affect price increases differently, giving rise to *inflation inequality*.

1. Data on the distribution of consumption by income quintile is from the 2015 Household Budget Survey.

Inflation traffic light

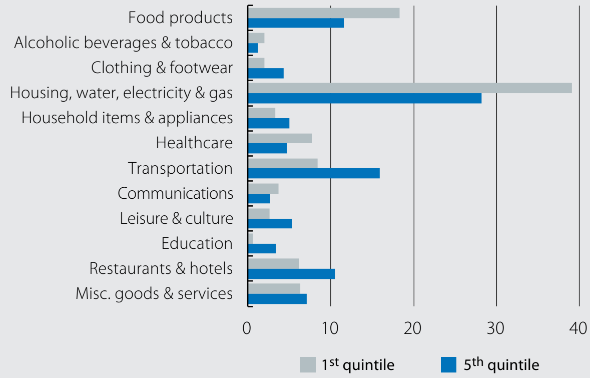
As a % of the price basket



Source: *BPI Research, based on data from the INE.*

Structure of consumption expenditures by income quintile

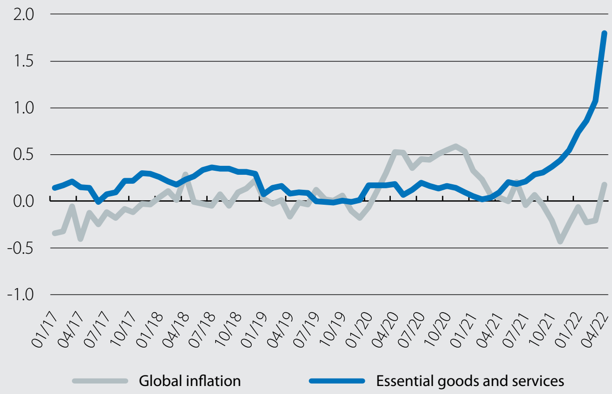
As a % of total expenditure



Source: *BPI Research, based on data from Eurostat.*

Inflation inequality between the lowest and highest income households

In percentage points (pp)



Source: *BPI Research, based on data from Eurostat and the INE.*

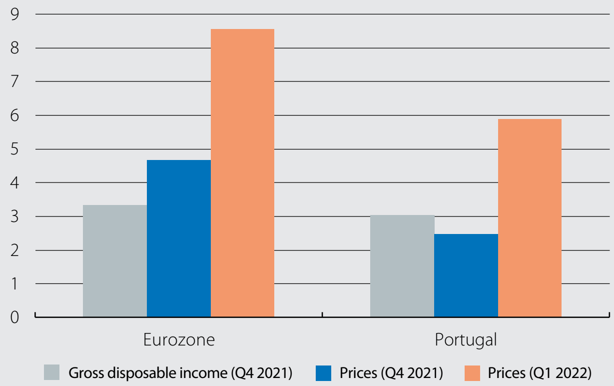
Using data from INE and Eurostat[2], we calculated two areas of *inflation inequality*, focusing on the index as a whole, but also on essential goods and services with less flexible demand (by adding the food component to the housing, water, electricity, gas and other fuels components). As can be seen, during practically the entire year after the outbreak of the pandemic and until mid-2021 there was «inflation inequality» throughout the entire index, meaning that lower income households were more affected by inflation, with this metric reaching the value of 0.6 pp in November 2020. In fact, average annual inflation in 2020 was –0.01%, but for the lowest income households it was effectively 0.3% and for the highest income households it was –0.1%, due to the fact that, during the year, prices were reduced in areas where higher income households spend a greater share of their budget, such as clothing and footwear, leisure and culture, education, etc.Globally, inflation inequality declined from July 2021 to March 2022, which was expected due to the aforementioned spread of high inflation throughout most of the basket. However, it gets much worse if we only consider essential goods and services, where inflation reached 1.8 pp last April.

This is the most worrying aspect of *inflation inequality*. Higher income households are able to offset the effect of price increases by reducing and postponing consumption or by using savings. The consequence of inflation inequality in essential goods might be an increase in the lack of basic necessities and a drastic reduction in disposable net income after basic needs have been covered. We performed our calculations using the weights in the 2015 market basket; however, it is entirely possible that consumption patterns will have changed after the pandemic, resulting in an increase in the weight of spending on essential goods by lower income households. This is especially worrying if we take into account the current context, in which household income after the Covid crisis has recovered, but cannot keep up with the rising cost of living.

The phenomenon does not seem to have escaped the attention of political leaders, and in the state budget for 2022 measures were included to respond to the impact of the increase in the price of essential goods. Among them, there is a €60 support voucher for the most vulnerable families to compensate for the increase in the price of the food basket (a measure that the government expects to reach more than 800 thousand households), and a Euros 10 allowance for three months to buy gas cylinders. It is

Gross disposable income and prices

As a % of variation versus Q4 2019



Source: *BPI Research, based on data from Eurostat.*

also likely that the measures specifically targeted at agricultural activities, such as the VAT exemption on feed and fertilisers, will not only support producers, but also somehow mitigate the increase in the price of food when it reaches the consumer. As inflation is transitory, these one-off and short-term measures should mitigate the harmful effect of price increases.[4]

2. From INE, year-on-year inflation by components measured by the CPI (Consumer Price Index). From Eurostat, see note 1.
3. The calculation method used is the same as indicated in the Claeys, G. and L. Guetta-Jeanrenaud (2022) document. « Who is suffering most from rising inflation? . Bruegel Blog, 1 February.

4. According to Eurostat, the income cut-off point for the 1st quintile in Portugal is Euros 6,967 per year. Direct support registered in the State Budget totals Euros 90 per household. In practice, in annual terms, this would equal a monthly income increase of 1.29%.

How might rising interest rates affect the budgets of families in Portugal?

The recent increase in inflationary pressures in the Eurozone has contributed to a significant shift in the ECB's monetary policy. If, at the beginning of the year, we expected the first increase in official interest rates to occur at the end of 2023, it is now highly probable that an increase will occur in the coming months. The change in the ECB's position is due to fears of a misalignment of inflation expectations in the medium and long term.

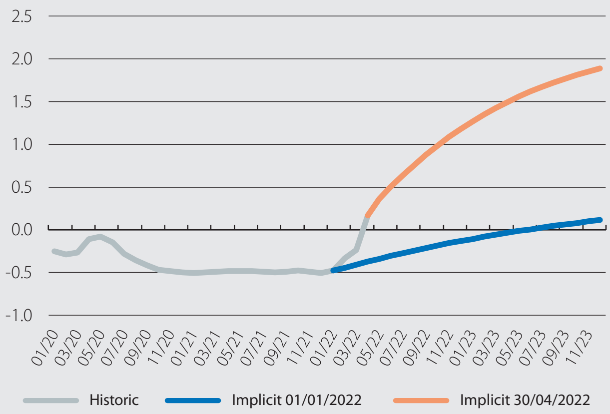
Expectations of a rise in official rates have already affected the interbank market. In mid-April, for example, the 12-month Euribor returned to positive territory after six years in the negative. The values recorded at the beginning of May (over +0.20%) represent a significant increase compared to the minimum recorded in 2021 (-0.49% on average in the year) and match values not seen since the beginning of 2015. Financial markets anticipate that this trend will continue in the coming months (see first graph).

The effect of the upwards trend in interest rates can already be seen in the mortgage market in Portugal, with the average interest rate on new housing loans rising to 1.03% in March, compared to 0.81% at the start of the year.

Developments in the loans market are important for the daily lives of Portuguese families. Indeed, around 68% of family indebtedness is related to housing loans, representing around 66% of gross disposable income. Since mid-2020, household debt for house purchases has been increasing, contrary to what has been observed in previous years, ending above pre-pandemic levels by almost 5% in 2021, but still clearly below the maximum observed at the end of 2010 (-20%, or -25,000 million euros).

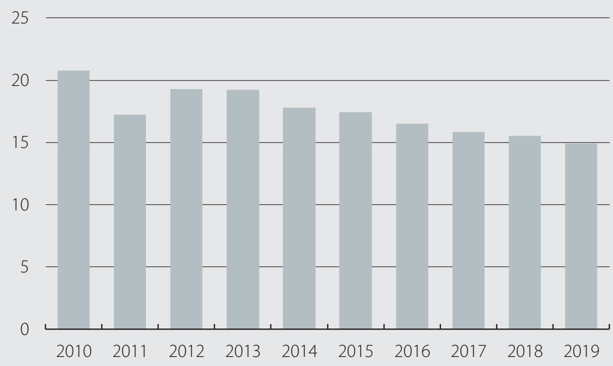
In this context, the evolution of interest rates becomes fundamentally important for those who have or intend to obtain mortgage loans. In the case of Portugal, interest rates are particularly important because the vast majority of contracts continue to be made with variable interest rates (unlike the rest of Europe): in 2020, more than 93% of the contracts in force were at variable rates, representing almost 92% of the outstanding balance. In that same year, more than 82% of the number of new contracts and the amount of new transactions were at variable rates[1] and the main indexes used were the

Euribor 12 months
(%)



Source: *BPI Research, based on data from Bloomberg.*

Median mortgage loan burden *
As a percentage of disposable income (%)



Note: ** Includes repayment of capital and interest.*
Source: *BPI Research, based on data from OECD.*

6- and 12-month Euribor.[2] Indeed, the extension of the period of negative interest rates led banks to grant new housing loans using the 12-month Euribor as the indexing factor.[3] At the same time, the average capital outstanding has been increasing, which together with the restrictions on the maximum maturity of new contracts, points to an increase in monthly housing costs. Indeed, contracts signed in the 3 months up to last March had an average outstanding principal of more than €123,000, which compares with €103,000 at the end of

1. In the Euro Zone, around 16% of new mortgage loans were taken out at variable rates in 2020. For more information, see Banco de Portugal (2021). "Retail Banking Markets Monitoring Report 2020".

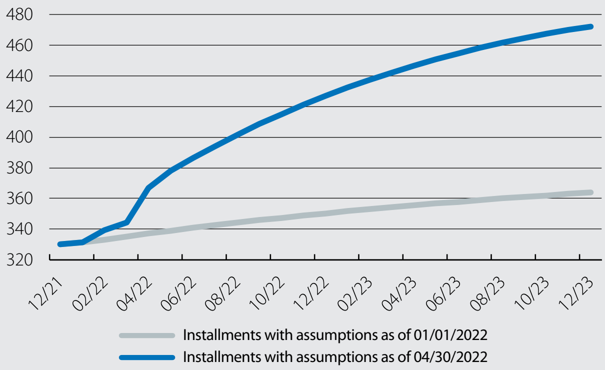
2. More specifically, and according to the source in note 1, of the contracts in force in 2020, 41.6% were indexed to the 6-month Euribor, 32.1% to the 3-month Euribor, and 24.5% to the 12-month Euribor. Considering the amount owed, however, the 12-month Euribor had a greater preponderance than the 3 and 6-month rates (37.4%, 30.7% and 30.9%, respectively).
3. Of the contracts signed in 2020, around 74% (in number and amount) were indexed to the 12-month Euribor and about 25% were indexed to the 6-month Euribor.

2019, a trajectory that tends to accompany the evolution of house prices themselves.[4] At the same time, an individual who owns a home with a mortgage loan spends around 15% of their disposable income on this loan (see second graph).[5] Similarly, around 18% of household expenditure relates to housing expenses.[6] In view of all these factors, there is no doubt that the evolution of interest rates has a significant impact on household budgets. This is evident in the third graph, where we estimate how the monthly installments on a home loan of 120,000 euros with a maturity of 33 years may evolve according to the market rates implicit for the 12-month Euribor.[7] The financial markets are anticipating the 12-month Euribor will reach 1.18% at the end of 2022, and 1.90% at the end of 2023, which compares with -0.50% at the end of 2021. If the projections implicit in the market are confirmed, this means that a borrower with a mortgage with these characteristics will pay 100 euros more a month at the end of this year than at the end of 2021, and 140 euros more at the end of 2023 than in December 2021. This contrasts significantly with what one would expect from market expectations in early 2022, whereby the increase at the end of 2022 was to be around 20 euros a month, and of around 35 euros at the end of 2023.

With the turnaround in interest rate expectations by the ECB, the recent change in macroprudential measures regarding maximum maturity and its dependence on the age of the borrower,[8] the expectation that house prices will continue to rise and significant growth in food and fuel prices, it is possible that housing demand will cool slightly in the coming period and that household budgets will come under further pressure.

Monthly installments on a loan of 120,000 euros, according to the evolution of the 12M Euribor

(Euros)



Note: *Assuming a loan of 120,000 euros over 33 years, with a spread of 1%, and market assumptions for Euribor 12M as of 01/01/2022 and 04/30/2022.*
Source: *BPI Research, based on data from Bloomberg and the National Institute for Statistics.*

4. The average outstanding principal has increased by around 20% year-on-year at the end of 2019, while house prices have increased by around 24% (source: National Statistics Institute and Confidencial Imobiliário).
5. Median expenditure on housing credit (interest and repayment) as a percentage of disposable income. Data from 2019 (OECD).
6. This also includes expenses for water, electricity and gas. Data from 2019 (OECD).
7. Implicit rates at end of April. A spread of 1% was assumed.
8. The maximum maturity for borrowers aged up to 30 years is 40 years, falling to 37 years for those aged between 30 and 35 years, and 35 years for those aged over 35 years.

In Portugal, inflation absorbs accumulated savings during the pandemic

The pandemic has created a savings cushion that will help households cope with rising inflation created by supply-side bottlenecks, exacerbated by the conflict in Ukraine.

The savings rate in 2021 was 10.9%, less than the 12.7% of 2020, but still 3.7 p.p. above the 7.2% of 2019. By value, household savings stood at €16.65 billion at the end of 2021, down €2 billion from 2020, but still €6 billion above the €10.7 billion of 2019.

The stronger growth in nominal consumption than in disposable income explains the decrease in savings in 2021. Indeed, while consumption increased by 4.8%, disposable income only grew by 3.2%. This trend is expected to intensify in 2022, with nominal consumption expected to grow by around 8%-9%, driven by the increase in inflation to levels above 5% and, perhaps, by some remaining expenditures withheld during the period of confinement which have not yet been restored. Meanwhile, disposable income should continue to grow at around 3.5%. In this context, the savings rate could fall to levels between 5%-7%.

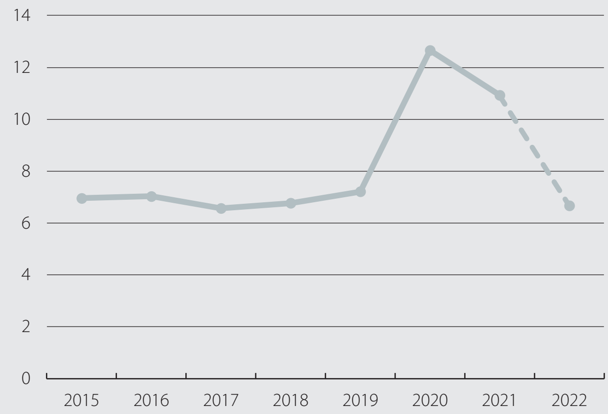
Our baseline scenario indicates that at the end of this year the savings rate will be closer to the upper limit of this range, given that the increase in savings, although common to all income levels[1], has been concentrated in the higher income levels, which usually have greater savings capacity and a lower propensity to consume. In addition, the uncertainty created by the war in Ukraine may generate more cautious behaviour, contributing to a less marked reduction in savings.

In any case, the return of savings rates to levels closer to 7% means that the savings accumulated during the pandemic will be fully absorbed by the increase in inflation, naturally affecting lower-income households more, whose accumulation of savings during the pandemic was lower.

Meanwhile, the financing capacity of households has decreased in 2021 by around €3 billion to €9.3 billion, a level still much higher than the about €4 billion seen in the pre-pandemic years. The context of low rates of return on deposits, favourable financial conditions and

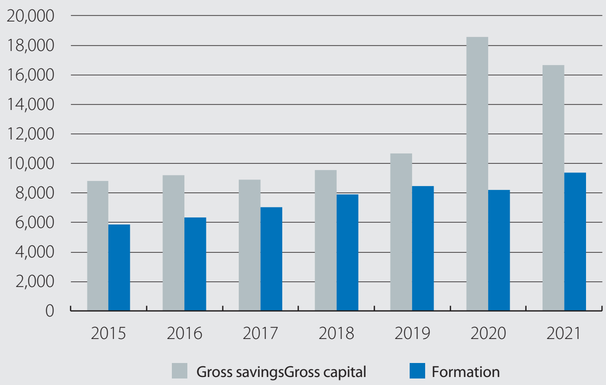
1. The Household Financial Situation Survey (ISFF) 2020, whose data was collected between October 2020 and February 2021, reports that the percentage of households saving in 2020 was growing faster among higher-income households than found in the previous survey conducted in 2017. In the lowest income quintile, 3% of households reported saving more than usual (2% in 2017), in the second 6% (3%), in the third 9% (3%), in the fourth 16% (6%) and in the highest quintile 22% (8% in 2017).

Portugal: savings rate
% disposable income



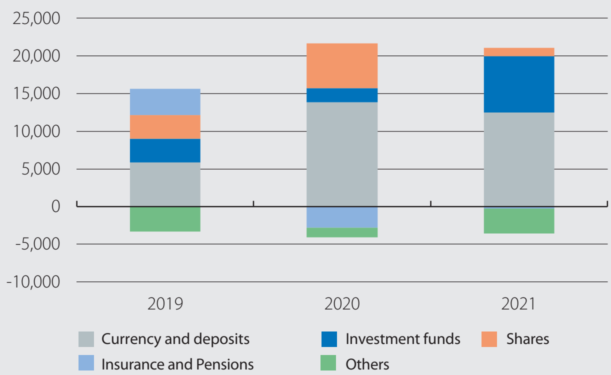
Source: *BPI Research, based on data from National Statistics Institute.*

Portugal: household savings and investment
(Millions of euros)



Source: *BPI Research, based on data from National Statistics Institute.*

Portugal: variation in household financial assets
(Millions of euros)



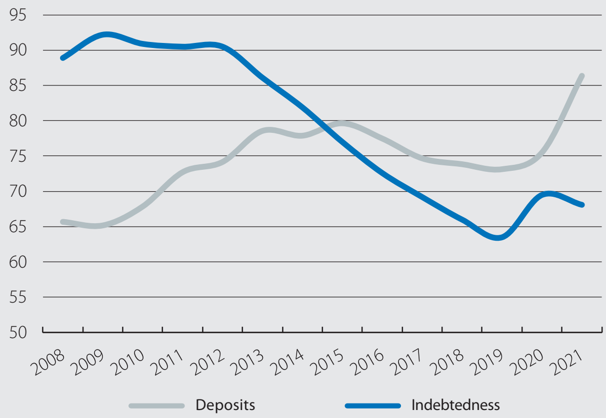
Source: *BPI Research, based on data from Banco de Portugal.*

accumulation of savings favoured investment in housing, justifying the fall in the financing capacity of families. Indeed, in 2021 more than 39,000 homes changed hands for a value of over 7 billion euros, 2 billion more than in 2020.

On the positive side, we highlight the fact that household financial assets increased last year, noting in particular the increase in deposits by around €11 billion to €173 billion, 6.8% more than in 2020, and increased investments in funds from 7.5 billion euros to 29.7 billion euros. In turn, indebtedness increased by 4.9 billion to 144 billion, 3.5% more than in 2022. In summary, the net financial wealth of households increased by around €14 billion to €297 billion, equivalent to 140.3% of GDP.

In short, the savings accumulated during the pandemic and more balanced household finances will help to face exceptionally high inflation.

Portugal: deposits and household debt
(% of GDP)



Source: _BPI Research, based on data from BdP and Eurostat._

Activity and employment indicators

Year-on-year change (%), unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	03/22	04/22	05/22
Coincident economic activity index	–5.5	3.1	2.8	5.3	6.1	7.0	7.1	7.0	...
Industry									
Industrial production index	–6.9	4.5	25.0	–4.7	–1.5	–2.3	0.5	...	...
Confidence indicator in industry *(value)*	–15.3	–5.3	–5.3	–1.5	–1.4	–0.1	–0.7	–0.9	–3.0
Construction									
Building permits - new housing (number of homes)	0.7	12.6	–28.7	–0.9	–7.2	40.0	–8.2	...	...
House sales	–11.2	20.5	58.2	22.1	17.2	–	–	–	–
House prices *(euro / m^2 - valuation)*	8.3	8.6	8.5	8.7	11.0	11.5	12.1	13.0	...
Services									
Foreign tourists *(cumulative over 12 months)*	–76.2	52.0	–74.2	–38.7	52.0	259.3	259.3	304.7	...
Confidence indicator in services *(value)*	–21.6	–2.9	–9.9	5.5	11.9	9.5	8.8	14.6	...
Consumption									
Retail sales	–3.0	4.9	16.5	3.1	7.3	12.7	9.9	6.3	...
Coincident indicator for private consumption	–6.2	4.8	4.9	7.5	7.3	6.4	5.9	5.2	...
Consumer confidence index *(value)*	–22.4	–17.2	–17.3	–13.6	–13.5	–19.3	–22.1	–27.2	–32.4
Labour market									
Employment	–1.9	2.8	4.5	4.7	3.1	4.7	4.0	3.5	...
Unemployment rate (% *labour force*)	7.0	6.6	6.7	6.1	6.3	5.9	5.8	5.8	...
GDP	**–8.4**	**4.9**	**16.5**	**4.4**	**5.9**	**11.9**	–	–	–

Prices

Year-on-year change (%), unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	03/22	04/22	05/22
General	0.0	1.3	0.8	1.5	2.4	4.3	5.3	7.2	8.0
Core	0.0	0.8	0.2	0.9	1.5	3.1	3.8	5.0	5.6

Foreign sector

Cumulative balance over the last 12 months in billions of euros, unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	03/22	04/22	05/22
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	–10.3	18.2	9.5	13.4	18.2	21.4	21.4	...	...
Imports *(year-on-year change, cumulative over 12 months)*	–14.8	21.4	1.8	10.3	21.4	33.4	33.4	...	...
Current balance	**–2.1**	**–2.4**	**–1.6**	**–1.9**	**–2.4**	**–3.7**	**–3.7**	**...**	**...**
Goods and services	–3.9	–5.6	–4.1	–4.4	–5.6	–6.9	–6.9	...	...
Primary and secondary income	1.7	3.2	2.5	2.5	3.2	3.2	3.2	...	...
Net lending (+) / borrowing (–) capacity	**0.0**	**1.4**	**0.6**	**1.5**	**1.4**	**–0.4**	**–0.4**	**...**	**...**

Credit and deposits in non-financial sectors

Year-on-year change (%), unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	03/22	04/22	05/22
Deposits [1]									
Household and company deposits	10.0	9.3	8.6	8.7	9.3	8.9	8.9	8.9	...
Sight and savings	18.8	16.3	15.3	15.5	16.3	15.3	15.3	14.9	...
Term and notice	1.2	1.2	1.0	1.0	1.2	1.1	1.1	1.6	...
General government deposits	–21.0	–4.1	–15.0	–5.2	–4.1	9.8	9.8	–2.0	...
TOTAL	**8.9**	**9.0**	**7.7**	**8.2**	**9.0**	**8.9**	**8.9**	**8.6**	**...**
Outstanding balance of credit [1]									
Private sector	4.6	2.9	4.4	4.2	2.9	2.8	2.8	2.7	...
Non-financial firms	10.5	2.2	7.2	5.8	2.2	1.2	1.2	1.0	...
Households - housing	2.1	3.3	2.6	3.3	3.3	3.0	3.0	3.0	...
Households - other purposes	–1.1	3.1	3.0	3.2	3.1	6.4	6.4	6.4	...
General government	–4.2	3.8	4.5	4.1	3.8	5.3	5.3	4.1	...
TOTAL	**4.2**	**2.9**	**4.4**	**4.2**	**2.9**	**2.8**	**2.8**	**2.7**	**...**
NPL ratio *(%)* [2]	**4.9**	**3.6**	**4.3**	**4.0**	**3.6**	**...**	–	–	–

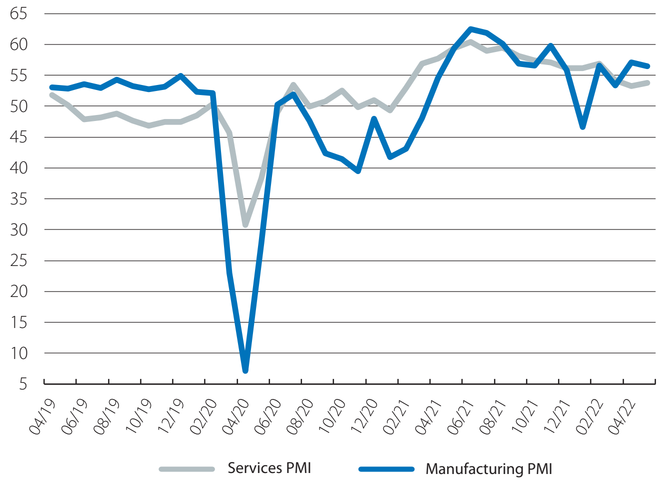
Notes: *1. Residents in Portugal. The credit variables exclude securitisations. 2. Period-end figure.*
Source: *BPI Research, based on data from the National Statistics Institute of Portugal, Bank of Portugal and Refinitiv.*

Spain: a complex environment, with good and bad news

The Spanish economy shows greater resilience than expected in the third month since the outbreak of the war, but the balance of risks is skewed to the downside. Three months have passed since the outbreak of the war and we now have a considerable amount of post-invasion data with which to make an assessment of the impact of the conflict on our economy. The shock of the war is filtering asymmetrically through the economy. On the supply side, the services sector, led by the sectors linked to tourism, continues to benefit from the fading of the pandemic and is enjoying a rapid recovery. In contrast, the agricultural sector and various branches of the industrial sector – those most exposed to the rises in energy, food and metal prices – are feeling the effects of the conflict to a greater degree. The manufacturing and services PMIs reflect these asymmetries: in May, the PMI for the services sector stood at 56.5 points, well above the 52.2-point average in Q1 2022, while the counterpart index for the manufacturing sector remained at a contained 53.8 points (55.8 in Q1 2022). On the demand side, there is growing concern about the rise in inflation and the impact it could have on private consumption. That said, the indicator scoreboard shows that the Spanish economy is currently weathering the storm successfully. Following the deterioration of the indicators in March, in April most have either stabilised, as is the case with the consumer confidence indicator published by the European Commission, or have rallied, as is the case with retail sales, which grew by 5.3% in April after falling 4.3% month-on-month in March. However, it should be noted that the balance of risks is clearly skewed to the downside. At the current juncture marked by the war, the risks in the geopolitical sphere have increased, and the consequences they could have for economic activity are potentially high.

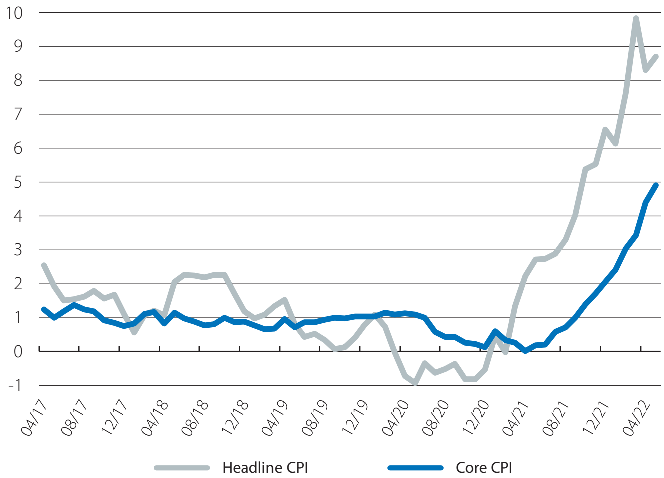
The peak in inflation appears to be behind us, but core inflation has picked up. The high level of inflation is one of the more concerning developments in the current environment. Having peaked at 9.8% in March, headline inflation moderated to 8.3% in April, but rose again to 8.7% in May. Inflation could remain below the March peak in the coming months as the electricity component, one of the main drivers of the inflation rally in 2021, will push inflation down: over the next few months the price of electricity will be compared with the months of 2021 when the price of electricity had already begun to climb. However, despite the gradual fading of the impact of higher electricity prices, the increase in energy costs is beginning to filter through to the rest of the components. In addition to this contagion effect, food prices are also being driven up as a result of the war. Thus, while headline inflation

Spain: PMI
Level



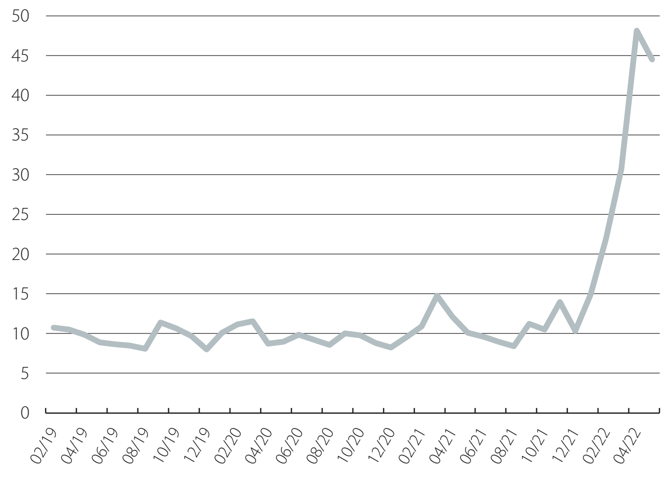
Source: *BPI Research, based on data from Markit.*

Spain: CPI
Year-on-year change (%)



Source: *BPI Research, based on data from the National Statistics Institute.*

Spain: permanent contracts registered
(% of the total registered in the month)



Source: *BPI Research, based on data from the Ministry of Work.*

has moderated, core inflation, which excludes energy and unprocessed food, has risen by 1.5 pps in just two months to 4.9% in May, its highest level since 1995.

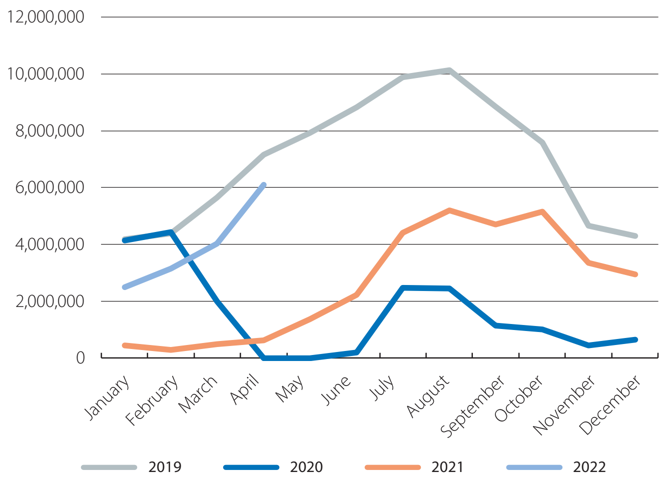
Employment continues to grow, driven by the recovery in the services sector. Despite the difficulties affecting the agrifood and industrial sectors in the current environment, job creation remains highly buoyant thanks to the recovery of the services sector. In May, Social Security affiliation grew by 33,366 workers in seasonally adjusted terms, the same as the previous month, bringing employment to 2.8% above the pre-pandemic level of February 2020. Recruitment on permanent contracts, meanwhile, is also on the rise and in May accounted for 44.5% of all contracts registered in the month. This increase in permanent hiring reflects the conversion of temporary jobs into permanent-discontinuous jobs induced by the recent labour reform. This process is already reflected in the Social Security affiliation figures: whereas the percentage of temporary workers traditionally fluctuated at around 30% of the total number of registered workers, this percentage now stands at around 22%. However, it should be recalled that in order to make a comprehensive assessment of the impact of the reform we must take into account not only the temporary employment rate, but also the impact on job creation.

The arrival of foreign tourists grows at a steady pace and promises a good summer season. In April, around 6.1 million tourists arrived and spent 6.9 billion euros. These figures mark a sharp acceleration in the pace of recovery: tourist arrivals stood 14.6% below the same month in 2019, compared to 28.6% below the pre-pandemic level in the previous month; and for the first time spending was very close to the pre-pandemic level, at just 2.2% below April 2019 (–16.0% in the previous month). A good tourist season will be key to cementing the recovery of the Spanish economy in 2022.

Home prices rally in a context of rising construction costs and booming demand. The valuation price of unsubsidised housing rose by a significant 2.4% quarter-on-quarter in Q1 2022 (6.7% year-on-year). This rally is occurring against a backdrop of a marked rise in construction costs (18.9% year-on-year in February) and a continued surge in demand, while supply is increasing more gradually. This price trend can be seen in other indicators too, such as those published by real estate portals and the repeated home sale index published by the Spanish Association of Registrars (Colegio de Registradores), which increased 10.6% year-on-year in Q1.

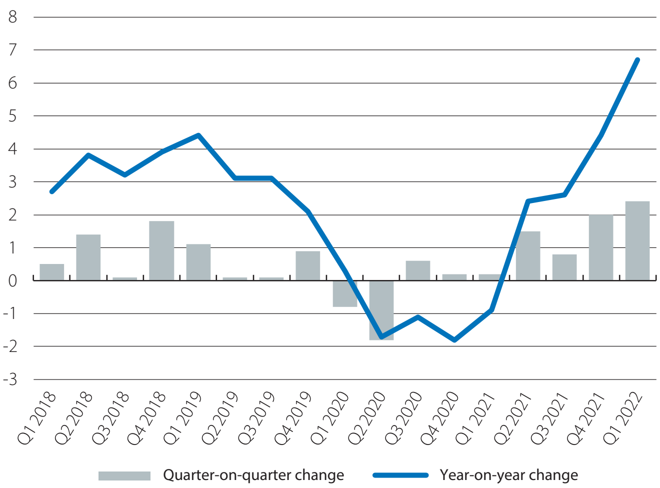
The government envisages a gradual reduction of the deficit. The Stability Plan for 2022-2025 foresees a deficit of 5.0% in 2022 and a gradual reduction to 2.9% by 2025. This reduction would be driven by the economic recovery that is expected to occur during this period and does not include any significant measures for reducing the structural deficit, which is expected to stand above 3%.

Spain: arrival of international tourists
(People)



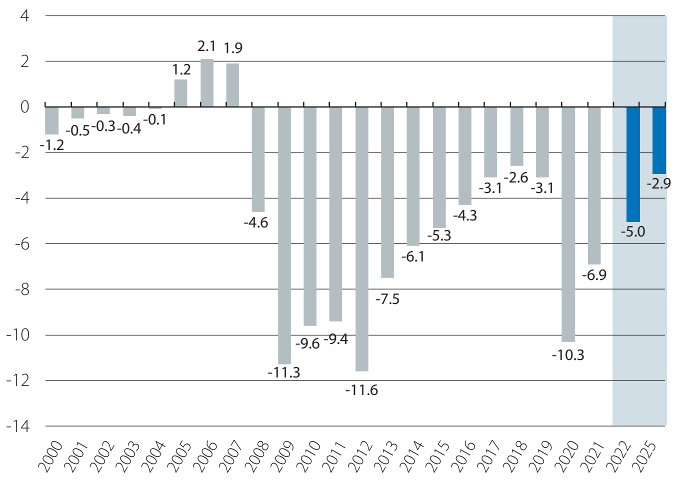
Source: *BPI Research, based on data from the National Statistics Institute.*

Spain: home prices (valuations)
Change (%)



Source: *BPI Research, based on data from the Ministry of Transport, Mobility and Urban Agenda (MITMA).*

Spain: general government balance
(% of GDP)



Source: *BPI Research, based on data from the 2022-2025 Stability Plan.*

The Stability Plan 2022-2025: correction of the budget deficit thanks to the business cycle

The economic recovery, key to bringing down the deficit

The Stability Plan for 2022-2025 presented by the Spanish government calls for a gradual reduction in the general government deficit, driven by the economic recovery, bringing it from 6.8% of GDP in 2021 down to 5.0% in 2022 and to 2.9% in 2025 (CaixaBank Research's forecast for 2025 places it still just above 3.0%). This is based on an inertial scenario, in that it does not incorporate new measures beyond those already approved for 2022, meaning that the structural deficit remains above 3% throughout the forecast horizon. Thus, the entire reduction in the budget deficit would come from its cyclical component, which will go from a deficit of 3.3% of GDP in 2021 to a surplus of 0.2% in 2025.

The macro outlook on which the Stability Plan is based is reasonable and has the AIReF's approval. The forecasts are for a cumulative economic growth of 12.5% between 2022 and 2025 (similar to our forecasts), with investment playing a major role in the next two years thanks to the NGEU programme.[1] This means that wage pressures will remain contained and that inflation will fall sharply from 2023 onwards.

Delving into the public accounts, on the revenue side there is no tax reform in the Plan. Revenues are expected to decline moderately as a percentage of GDP to 41.3% of GDP in 2025 (43.7% in 2021) due to a moderation in non-tax revenues (which includes income from capital transfers and European funds, excluding funds from the NGEU Recovery and Resilience Facility). Specifically, non-tax revenues would go from 4.9% of GDP in 2021 to 3.3% of GDP in 2025. Nevertheless, the tax burden is expected to remain stable (taxes and social security contributions will grow in line with nominal GDP).

Public spending would fall significantly as a percentage of GDP, owing to the significant increase in nominal GDP and some containment of non-pension spending. Thus, primary public expenditure (i.e. excluding interest payments) would fall from 48.4% of GDP in 2021 to 42.2% in 2025. Most notable is the reduction (as a percentage of GDP) in employee wages, expected to shrink from 18.1% in 2021 to 16.1% in 2025. This is a plausible result in a context of strong nominal GDP growth and considering that wage rises had already been agreed prior to the inflation rally. In contrast, pension expenditure, which in theory is tied by law to inflation, is expected to continue to grow at a rate similar to nominal GDP.

As for interest charges, a key variable for debt sustainability, the Stability Plan projects that this item will continue to fall in GDP terms to 2.1% of GDP in 2025 (2.2% in 2021), thanks to GDP growth and an assumption that rates will remain very low (the Stability Plan assumes that the Spanish 10-year bond will remain stable at

1. Investment in capital goods is expected to grow by 11.4%, while investment in intellectual property products is expected to accelerate by 17.5% in 2022. From 2024 onwards the positive impact of NGEU will still be apparent, through the effects of ongoing structural reforms (notably the labour reform, business climate, training and the self-consumption of energy and green hydrogen).

Spain: macro scenario of the Stability Plan

	2021	2022	2023	2024	2025
Real GDP growth (%)	5.1	4.3	3.5	2.4	1.8
Nominal GDP growth (%)	7.4	8.5	5.9	4.3	3.7
Unemployment rate (%)	14.8	12.8	11.7	10.6	9.6
Employee wages (% growth)	–0.6	3.2	2.9	1.6	1.7
Private consumption deflator (% growth)	1.9	6.1	2.2	1.6	1.6
3-month Euribor (%)	–0.5	–0.4	0.3	0.7	0.7
Spanish 10-year bond rate (%)	0.1	0.8	1	1.1	1.1

Source: *Stability Plan 2022-2025, government of Spain.*

Spain: government Stability Plan for 2022-2025

Key elements	2021 (% of GDP)	2022 (% of GDP)	2025 (% of GDP)
Total public revenues	**43.7**	**42.0**	**41.3**
Indirect taxes (VAT, etc.)	12.1	12.0	11.6
Direct taxes	11.9	11.8	12.1
Social security contributions	14.3	13.7	13.9
Total public expenditure	**50.6**	**47.0**	**44.3**
Employee wages	12.2	11.5	10.9
Social benefits (not in kind)	18.9	17.6	17.6
Public investment	4.6	3.6	2.7
Interest expense	2.2	2.2	2.1
Fiscal balance	–6.8 *	–5.0	–2.9
Primary balance	–4.6	–2.8	–0.9
Cyclical balance	–3.3	–1.5	0.2
Structural balance	–3.1	–3.4	–3.2

Notes: *The projections incorporate the macro impact of NGEU but do not incorporate the European NGEU funds within revenue or expenditure. * The deficit in 2021 would be 6.9% of GDP including Sareb. Public investment is the sum of gross capital formation and capital transfers.*
Source: *Stability Plan 2022-2025, government of Spain.*

around 1% between 2022 and 2025, although it has recently climbed to 2.0%). In a scenario in which rates gradually rise from their current levels (e.g. with the 10-year bond at around 3.0% in 2025), the debt burden could pick up slightly in 2025, although it would still be well below the 3.0% reached in 2012,[2] according to our sensitivity analysis.[3]

Finally, public debt would gradually decline as a percentage of GDP, but would still remain high, going from 118.4% in 2021 to 109.7% in 2025. The bulk of the reduction is due to GDP growth in nominal terms; the Plan envisages cumulative nominal GDP growth of 24.3% between 2022 and 2025.

The public accounts of the future: a comparison of 2025 with the pre-pandemic world

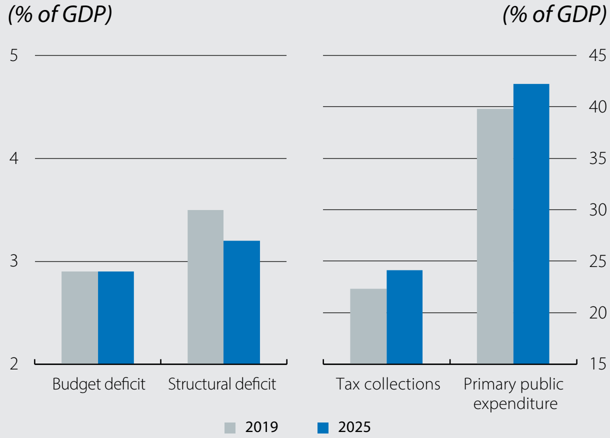
An interesting exercise is to compare the state of the public accounts as projected by the government for 2025 in the Stability Plan with that of the pre-COVID world. There are three key outcomes worth highlighting:

– ***In 2025, the relative weight of the public sector in the economy will be greater than in 2019***; specifically, it will be over 2.0 pps higher in GDP percentage terms. This suggests there will be a structural step change in public spending, due to factors such as the indexation of pensions to inflation[4] and a structural increase in healthcare spending.

– ***The structural deficit will be very similar in 2025 (3.2%) to 2019 (3.5% of GDP)***. The reason is that, although expenditure will increase, revenues are also expected to rise to a similar degree (see third result).

– ***The government projects that the increase in tax revenues, following the large increase in collections in 2021, will be consolidated without the need for new tax measures***. Thus, according to the Stability Plan, tax revenues as a percentage of GDP will be 1.8 pps higher in 2025 than in 2019. This is based on an inertial approach, with the assumption that tax revenues can be maintained at levels similar to 2021 (24.5% of GDP) in 2025 (the projection is 24.1%), well above that of the pre-COVID world.[5] The question is whether this increase in revenues will be structural. The digitalisation of the economy during the pandemic may have reduced the shadow economy, which would support such a scenario. However, the increase in direct taxation in 2021 may be related to the exceptional measures implemented during the pandemic, such as the ERTE furlough schemes.

Spain: comparison of the public accounts in 2025 and 2019



Note: *The deficit in 20219 excludes Sareb.*
Source: *BPI Research, based on data from the Stability Programme for 2022-2025 and for 2021-2024.*

2. In 2012, public debt represented 86% of GDP, well below the current level.
3. See the Focus «The impact of financial conditions on Spain's public debt burden» in the MR03/2022.
4. It appears that social benefits, the main component of which is pension expenditure, have permanently increased and will be 1.8 pps higher as a percentage of GDP in 2025 than before the pandemic.
5. Tax revenues in 2021 as a percentage of GDP were around 1 pp higher than in the last 30 years.

Good outlook for the tourism sector

International mobility is recovering at a rapid pace thanks to the perception among the population that the risks associated with the pandemic are fading. This confidence is not misplaced, since the Omicron variant has been milder, there is a very high vaccination rate, and the level of natural immunity – caused by the high number of winter infections – is now much higher.

The tourism sector is proving to be one of the biggest beneficiaries of this trend. The sectoral indicators paint a very positive picture for the remainder of 2022, meaning that the sector can act as a driver for the Spanish economy at a time when many other sectors are enduring a difficult context.

High-frequency indicators

One of the real-time indicators that gives us a reliable view of the trend in tourism demand, excluding the price effect, is that of the number of flights that are operated, provided by Eurocontrol. As the first chart shows, in the second week of May the number of flights operated in Spain was just 7% below the same period in 2019. This represents a significant improvement since January, when the number of flights was 30% below due to the Omicron wave, as well as marking a major milestone as it means that the peak weekly flight volume of 2021 (reached in the first week of August) has been exceeded.

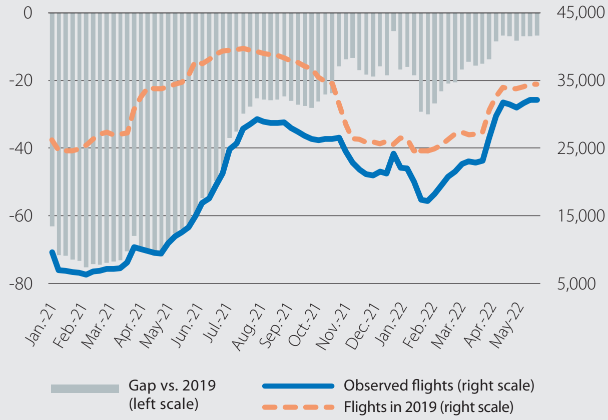
If we look at passenger data by country of origin of the flights, published monthly by AENA, we can get a better idea of what is driving this recovery. As can be seen in the table, the main protagonist of the recovery is British tourism, due to its significant improvement and its importance for the Spanish tourism sector. In 2021, the number of passengers arriving from the UK performed worse than those from EU countries, due to the popularisation of staycations among the British population. The latest data for 2022, in contrast, point to declines of just 16% compared to the same period in 2019. On the other hand, long-haul flights are also showing very good dynamics in 2022, confirming that the aversion to travel is receding on a more global scale. The domestic market, meanwhile, is still looking healthy. Moreover, the drop in air connectivity with Russia, which is evident in the decline in passenger numbers coming from the «Rest of Europe», is not having a significant effect on the overall figures given its low relative weight in the total volume of arrivals.

2022 outlook

Forward-looking indicators, such as the volume of bookings or indicators suggestive of the level of interest

Spain: flights operated at Spanish airports

Change versus 2019 (%) *Weekly flights*



Source: *BPI Research, based on data from Eurocontrol.*

Spain: passenger arrivals according to the country of origin of the flight

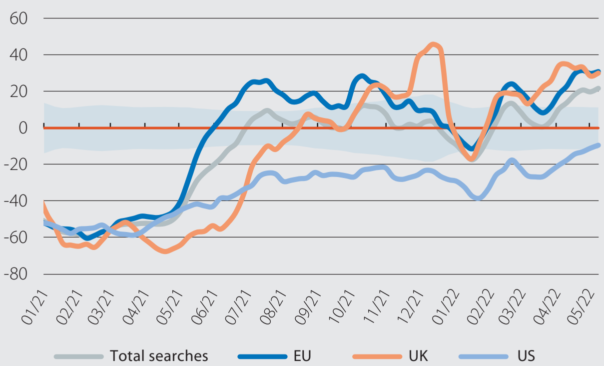
Change versus the same period in 2019 (%)

	Q1 2021	Q2 2021	Q3 2021	Q4 2021	Jan.-22	Feb.-22	Mar.-22	Apr.-22	
Total	–84	–75	–42	–28	–38	–26	–21	–12	↑
Domestic	–74	–56	–16	–19	–28	–20	–17	–6	↑
International	–90	–83	–52	–33	–43	–29	–24	–14	↑
EU	–90	–76	–41	–25	–40	–27	–22	–11	↑
United Kingdom	–98	–97	–70	–45	–58	–32	–25	–16	↑↑
Rest of Europe	–87	–87	–76	–47	–37	–36	–57	–56	↓↓
US & Canada	–97	–92	–75	–63	–45	–43	–34	–24	↑↑
Latin Am.	–79	–77	–58	–36	–20	–6	0	8	↑↑
Rest of the world	–78	–82	–55	–44	–51	–40	–29	–32	↑

Source: *BPI Research, based on data from AENA.*

Weekly Google searches on trips to Spain

Change versus the benchmark level



Notes: *Data on searches conducted for the word Spain in the United Kingdom, Germany, France, Italy, the Netherlands and the US in the official language of each country within the travel category. The benchmark level consists of the forecast number of searches expected to be made a year in the future, using an ARIMA (1, 1, 1)$_{52}$ model with data between January 2015 and December 2020. The shaded area reflects the 68% confidence interval (a = 1).*

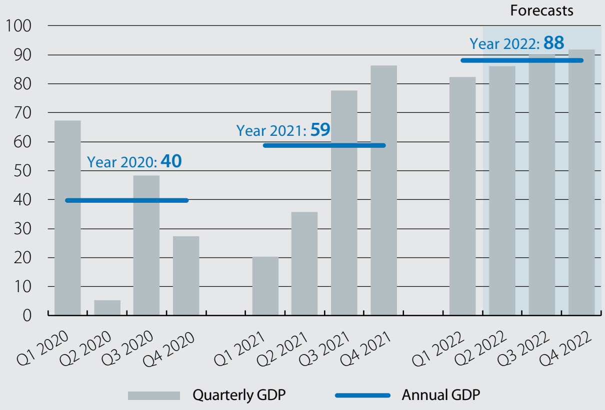
Source: *BPI Research, based on data from Google Trends.*

(Internet searches), anticipate a clear improvement for the summer season. Specifically, Google searches for travel to Spain from Western European markets are over 20% above their usual pre-pandemic levels, and even searches from the US were within their usual range for the first time since the pandemic began.

Looking at 2022 as a whole, the strong inertia in the recovery of tourism from the EU, and above all from the United Kingdom, combined with the better than expected recovery in demand from American markets offers a very positive outlook for the sector. Despite this, it should be noted that the macroeconomic environment emerging as a result of the war in Ukraine, with the surge in energy and agrifood commodity prices, will affect the sector's cost structure, exerting some pressure on sale prices and business margins.[1] In any case, demand does not appear to be reacting negatively to the inflationary shock.

In this context, we forecast that tourism GDP this year will stand at 88% of 2019 levels, with 50% growth over 2021. With this, tourism sector activity would not recover to pre-pandemic levels this year, but it would reach a level similar to that of 2017, when the sector performed very well.

Spain: evolution of tourism GDP
Índex (100 = 2019)



Source: *BPI Research.*

1. See the Focus «Which sectors are most affected by the conflict in Ukraine?» in the MR04/2022.

Long-term investment trends in Spain

Investment plays a key role in determining a country's economic growth potential. The quantity and quality of the stock of a country's productive capital largely determines its ability to adapt to economic transformations and, therefore, its economic growth. Therefore, one of the main challenges in order for the Spanish economy to successfully navigate the current context of rapid technological innovations is to reorient its productive factors. This is a necessary step in order to boost productivity and facilitate the transformation of the country's productive model.

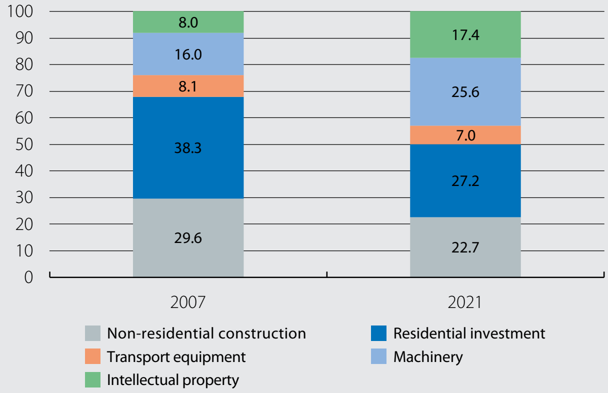
This is the first of two articles devoted to the analysis of investment in Spain. In this first article, we will explore the changes that have taken place in the last decade in the composition of investment in Spain. The second one, meanwhile, focuses on investment trends since the beginning of the pandemic, as well as the signals that can be drawn from the latest investment indicators.

Structural changes in the composition of investment

The first chart shows a comparison between the structure of investment in Spain in 2007, the year before the start of the financial crisis, and in 2021, the last year for which data are available. Several messages can be drawn from the chart. First of all, we see a sharp fall in the relative weight of investment in construction in the last 14 years, including both non-residential construction and, above all, residential construction. Whereas investment in construction accounted for almost 68% of total investment in 2007, by 2021 this proportion had fallen to around 50%. Of course, this decline reflects the sharp contraction in the housing market since the financial crisis, which has led to a structural shift in the relative weight of this sector in the economy as a whole: investment in construction (residential and non-residential) in 2021 stood 41% below the level of 2007 (in real terms).

Secondly, we see that investment in both machinery and intellectual property – the latter mainly materialising in the form of intangible assets – have seen their relative weight significantly increase, especially in the case of investment in intangible assets, which has more than doubled as a proportion of the total between 2007 and 2021. The greater role of these categories not only reflects an automatic impact resulting from the sharp fall in construction investment, but it is also the result of significant growth in investment in absolute terms: investment in intangibles in real terms was 43% higher in 2021 than in 2007, while investment in machinery was 20% higher. The rise of investment in intangibles is linked

Spain: structure by type of investment
(% of total investment)



Source: *BPI Research, based on data from the National Statistics Institute.*

to the phenomenon of digitalisation – a technological transition which is revolutionising productive processes across the economy and which is more intensive in this type of investments.[1] The growth of investment in machinery, meanwhile, reflects the recovery of the industrial sector in the wake of the financial crisis, the investment needs associated with the pre-pandemic digitalisation process, as well as the rotation that the Spanish economy experienced during the recovery years as it shifted towards a more export-intensive economy – a transition which required significant investment.

Converging on European investment patterns

How does the pattern of investment in Spain compare with that of the major European economies? Let us first make a comparison in relative terms and then in terms of the structure of investment.

The second chart shows the pattern followed by investment in Spain and other major euro area economies as a percentage of GDP. We see how investment in Spain reached as high as 30% of GDP in the run-up to the financial crisis. This is much higher than in neighbouring economies and was fuelled by the strong growth in construction investment. We also see that the correction in the real estate sector beginning in 2008 had a significant impact on investment: by 2013 investment had fallen to a low of 17.2% of GDP. Since then, and driven by the categories mentioned earlier, investment has been recovering lost ground and has stood at around

1. Unlike more traditional investment assets, intangible assets lack a physical component. They include investment in software, patents, databases and training, among others.

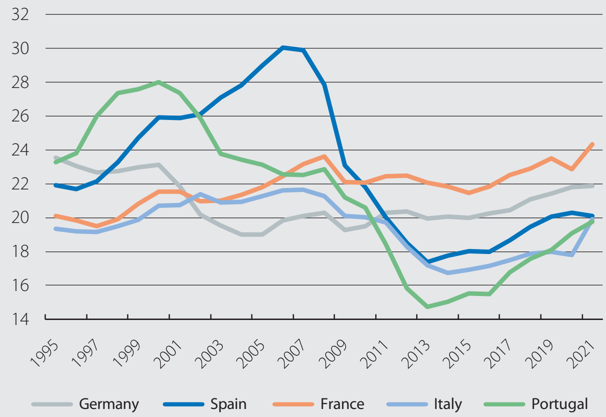
20% of GDP since 2019. However, although it is not far off, we see that investment in Spain is still somewhat below that of countries such as France and Germany.

How does the structure of investment in Spain compare with that of other European economies? As can be seen in the third chart, the structure of investment in Spain in 2021 was quite similar to that of other large European economies. In particular, we see that the relative weight of investment in construction in our economy is similar to that of others and, with the exception of certain idiosyncratic cases, the same can be said of investment in intangibles and in equipment and transport goods.

However, although the structure of investment in Spain today is similar to that of the large European economies, this was not the case 10 years ago. At that time, investment in construction in Spain represented a much higher proportion of the total compared to the other major European countries, while investment in intangibles was much lower. Thus, the gap in the cumulative capital invested in intangibles and machinery is still substantial. As an example, according to data from EUKLEMS, in Spain in 2016 (the last available figure), the level of capital in intangibles amounted to 6,750 euros per worker, compared with 13,300 euros per worker in France and 10,450 euros in Germany. Thus, given that the percentage of GDP we allocate to investment is similar to that of France or Germany, in the case of Spain we would need to allocate a higher proportion of total investment to these categories compared to those other economies, and for a longer period of time, in order to converge on their level of investment in terms of capital per worker.

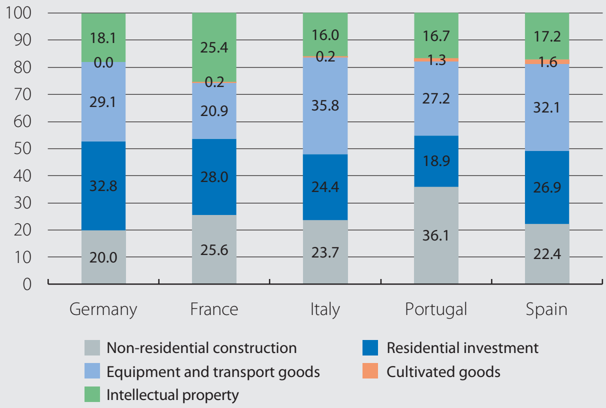
In this regard, the European funds from the NGEU programme are a key element. Not only will they provide a boost to investment, but if the projects are well chosen they also offer a unique opportunity to modernise the productive assets of the Spanish economy.

Euro area: investment
(% of GDP)



Source: *BPI Research, based on data from Eurostat.*

Euro area: comparison of the structure of investment by component
(% of total investment)



Source: *BPI Research, based on data from Eurostat.*

Short-term investment trends in Spain

In this second article devoted to the analysis of investment in Spain, we focus on how investment evolved during the pandemic and we analyse the signals offered by the latest indicators related to gross capital formation.

Investment trends during the pandemic

The pandemic has had a very asymmetric impact on the various components of investment (see first chart). Whereas investment in intangibles and in machinery have recovered and exceeded pre-crisis levels, investment in construction and, above all, in transport equipment still remain well below.

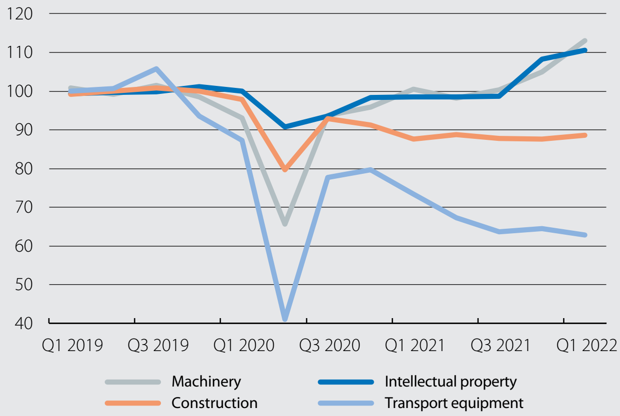
As pointed out by Pacce (2022),[1] this asymmetric behaviour reflects the nature of the pandemic itself, which dealt a heavier blow to sectors which involve more in-person human interaction. Thus, activities related to the services sector were more affected than industrial activities. Nevertheless, to the extent that the services sector is less intensive in machinery investment, this type of investment would have been less adversely affected during the pandemic. In addition, the significant investments made in digitalisation in order to enable teleworking and e-commerce will have fuelled investment in both intangibles (i.e. intellectual property) and machinery (which includes computer equipment). Finally, although we could expect the rise of e-commerce to have provided a boost to investment in transport equipment, given the deliveries it involves, the impact of the mobility restrictions and the blow dealt to national and international tourism more than offset that investment boost, thus depressing investment in this category overall.

The latest indicators

What do the latest investment-related activity indicators, especially those related to investment in machinery, tell us? Unfortunately, we still do not have any hard indicators, based on firm data, for Q2 2022. That said, we do have soft indicators, referring to economic agents' confidence levels and expectations, as well as indicators related to the main factors that determine investment (see second chart).

The degree of utilisation of the productive capacity in industry is an early indicator of investment, given that when it reaches high levels it indicates the need for investment in order to increase the productive capacity

Spain: pattern of investment
Index (100 = 2019)



Source: *BPI Research, based on data from the National Statistics Institute.*

and ensure demand can be met. The level of confidence in industry is also an important indicator, because uncertainty delays the start-up of new investment projects. Finally, we consider the responses to the European Commission's quarterly survey of industrial companies regarding which factors are limiting their production.[2]

As can be seen in the second chart, in general all the indicators are above their historical average, so we could expect to see an expansive tone in investment. In particular: the degree of utilisation of productive capacity is high; confidence, although dented since the outbreak of the war between Russia and Ukraine, remains at levels similar to those of pre-pandemic years, and demand is also relatively high.

However, there is a sharp deterioration in the indicator citing the shortage of materials or equipment as one of the main obstacles to production. This indicator reminds us of the difficulties the industrial sector is currently experiencing due to the disruptions in global supply chains – a phenomenon we have analysed in other articles.[3]

Thus, the outlook for the coming months is uncertain. The encouraging pattern in the indicators mentioned above reflects an economic environment that is

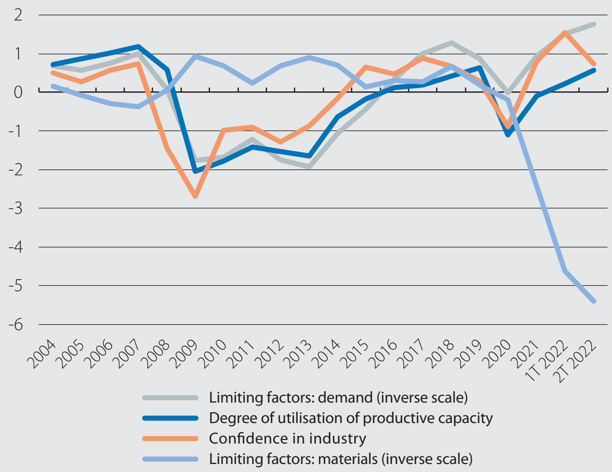
1. See M.J. Pacce «El comportamiento de la inversión en equipo durante la pandemia: el papel de su composición sectorial». Economic Bulletin 2/2022. Bank of Spain (content available in Spanish).

2. In the second chart we show the responses to the questions as to whether the shortage of materials or equipment and the shortage of demand are limiting factors, although more options are included in the European Commission's survey.
3. See, for instance, «Bottlenecks: from the causes to how long they will last» in the MR12/2021, or «Supply chains: no escalation in the disruptions», in the MR02/2022.

conducive to investment growth and a context that is marked by the fading impact of the pandemic and by the effects of the European NGEU funds. It should be recalled that NGEU represents a significant boost to investment. In 2022 alone, the General Government Budget includes investments funded by NGEU amounting to around 27 billion euros, or 2.2% of 2021 GDP, including 10 billion allocated for projects related to the industrial sector and the digitalisation of the economy. However, heightened uncertainty related to the war and the bottlenecks could delay the implementation of many projects, including those related to NGEU, taking the shine off what would otherwise have been a very vigorous pattern of investment growth.

Spain: soft indicators related to investment in capital goods

*Standardised index **



Note: ** Each series has been standardised and has a mean average equal to 0 and a standard deviation equal to 1.*
Source: *BPI Research, based on data from the European Commission.*

Activity and employment indicators

Year-on-year change (%), unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	03/22	04/22	05/22
Industry									
Industrial production index	–9.5	8.8	28.7	1.9	1.5	1.6	0.1	...	...
Indicator of confidence in industry *(value)*	–13.6	0.6	–0.2	2.3	4.9	6.9	4.4	–1.2	1.3
Manufacturing PMI *(value)*	47.5	57.0	59.2	58.9	56.9	55.8	54.2	53.3	...
Construction									
Building permits *(cumulative over 12 months)*	–12.8	4.7	–1.8	15.0	24.6	31.6	32.0	...	...
House sales *(cumulative over 12 months)*	–12.5	9.5	0.7	22.3	32.4	41.7	42.0	...	...
House prices	2.1	3.7	3.3	4.2	6.4	...	–	–	–
Services									
Foreign tourists *(cumulative over 12 months)*	–77.3	64.7	–75.8	–34.5	64.7	313.4	313.4	...	...
Services PMI *(value)*	40.3	55.0	58.8	59.6	57.4	52.2	53.4	57.1	...
Consumption									
Retail sales	–7.1	5.1	20.3	–0.4	0.7	0.4	–4.1	1.5	...
Car registrations	–29.3	158.0	661.0	–24.5	–17.1	–7.5	–30.2	–12.1	...
Consumer confidence index *(value)*	–22.8	–12.8	–10.1	–9.1	–13.1	–17.3	–28.2	–26.9	–22.6
Labour market									
Employment [1]	–2.9	3.0	5.7	4.5	4.3	4.6	–	–	–
Unemployment rate (% labour force)	15.5	14.8	15.3	14.6	13.3	13.6	–	–	–
Registered as employed with Social Security [2]	–2.0	2.5	3.9	3.8	3.9	4.5	4.8	5.1	...
GDP	**–10.8**	**5.1**	**17.8**	**3.5**	**5.5**	**6.4**	–	–	–

Prices

Year-on-year change (%), unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	03/22	04/22	05/22
General	–0.3	3.1	2.6	3.4	5.8	7.9	9.8	8.3	8.7
Core	0.7	0.8	0.1	0.8	1.7	3.0	3.4	4.4	4.9

Foreign sector

Cumulative balance over the last 12 months in billions of euros, unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	03/22	04/22	05/22
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	–10.0	21.2	8.7	15.2	21.2	26.2	26.2	...	...
Imports *(year-on-year change, cumulative over 12 months)*	–14.7	24.8	3.3	13.5	24.8	36.1	36.1	...	...
Current balance	**9.3**	**11.3**	**9.2**	**11.6**	**11.3**	**10.6**	**10.6**	...	...
Goods and services	16.5	18.2	17.1	19.2	18.2	17.1	17.1	...	...
Primary and secondary income	–7.3	–6.9	–7.9	–7.7	–6.9	–6.5	–6.5	...	...
Net lending (+) / borrowing (–) capacity	**13.7**	**22.3**	**15.2**	**19.7**	**22.3**	**22.9**	**22.9**	**...**	**...**

Credit and deposits in non-financial sectors [3]

Year-on-year change (%), unless otherwise specified

	2020	2021	Q2 2021	Q3 2021	Q4 2021	Q1 2022	03/22	04/22	05/22
Deposits									
Household and company deposits	7.5	6.1	4.9	4.8	5.8	5.1	5.5	...	...
Sight and savings	12.3	10.3	9.2	8.9	9.2	9.2	9.6	...	...
Term and notice	–16.5	–24.4	–23.5	–26.0	–27.6	–26.8	–26.3	...	...
General government deposits	1.0	15.5	16.3	15.1	19.4	19.2	18.5	...	...
TOTAL	**7.1**	**6.7**	**5.5**	**5.5**	**6.6**	**5.9**	**6.2**	**...**	**...**
Outstanding balance of credit									
Private sector	1.2	0.3	–0.4	–0.7	–0.1	0.1	–0.1	...	...
Non-financial firms	4.9	1.1	–0.7	–1.9	–0.9	–0.6	–1.3	...	...
Households - housing	–1.8	0.2	0.0	0.6	1.0	1.3	1.3	...	...
Households - other purposes	0.8	–1.2	–0.7	–1.2	–1.2	–1.2	–1.2	...	...
General government	3.0	15.3	17.4	22.7	11.6	3.6	2.4	...	...
TOTAL	**1.3**	**1.1**	**0.6**	**0.7**	**0.6**	**0.3**	**0.0**	**...**	**...**
NPL ratio (%) [4]	**4.5**	**4.3**	**4.5**	**4.4**	**4.3**	**...**	**...**	**...**	**...**

Notes: *1. Estimate based on the Active Population Survey. 2. Average monthly figures. 3. Aggregate figures for the Spanish banking sector and residents in Spain. 4. Period-end figure.*
Source: *BPI Research, based on data from the Ministry of Economy, the Ministry of Public Works, the Ministry of Employment and Social Security, the National Statistics Institute, the State Employment Service, Markit, the European Commission, the Department of Customs and Special Taxes and the Bank of Spain.*

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