MR11

MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK

NOVEMBER 2022

ECONOMIC & FINANCIAL ENVIRONMENT

FINANCIAL MARKETS

Stormy waters in the UK, a warning to seafarers

INTERNATIONAL ECONOMY

US: controlled slowdown or hard landing in the housing market?

ECONOMIA PORTUGUESA

«Habemus Pactum»*: agreement on income and competitiveness will be a guideline until 2026*

A year of uncertainty prompts a measured State Budget

Consumption in 2023: what to expect

Recovery and Resilience Plan: situation

SPANISH ECONOMY

The public accounts in 2023: increase in revenues and also in expenditure

DOSSIER: 2023 OUTLOOK

Winds of change

Is there light at the end of the tunnel? The outlook for monetary policy in 2023

Economic policy in the face of the energy challenge: supporting the most vulnerable without distorting the economy

Portugal in 2023: a year of clenched teeth?

BPI

MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK
November 2022

The *Monthly Report* is a publication developed jointly by CaixaBank Research and BPI Research (UEEF)

BPI Research (UEEF)
www.bancobpi.pt / http://www.bancobpi.pt/grupo-bpi/estudos-e-mercados/mercados-financeiros
Paula Carvalho
Chief Economist

CaixaBank Research
www.caixabankresearch.com
research@caixabank.com
Enric Fernández
Chief Economist
José Ramón Díez
Head of International Economies and Financial Markets
Oriol Aspachs
Head of Spanish Economy
Sandra Jódar
Head of Strategic Planning
Clàudia Canals and Nuria Bustamante
Monthly Report coordinators
Javier Garcia-Arenas
Dossier coordinator

Date this issue was closed:
7 November 2022

ÍNDICE

Geopolitics, geopolitics and, for dessert, geopolitics

An age of economic prosperity and social transformation has undeniably been underpinned by recent technological revolutions. Today, immersed in the world's changing climate and in the midst of an intense geopolitical battle that will likely lead to a multipolar world, major economies have to decide on their strategy. Such a strategy must be formulated along numerous fronts, including, as we have seen, a prominent role for government, even in countries that have clearly exemplified a more economically liberal approach for decades, such as the US.

Indeed, just a few days ago, the Biden administration increased restrictions on the purchase of American processor chips by Chinese companies or individuals. Limiting the use of such advanced technologies is an effective way to prevent countries from emerging, and the US is clearly including this technological limitation as a way to restrict the strategic relevance of China, a country with a political, social and economic system that is markedly different from that of the Western world.

In Europe, first the pandemic and then the war in Ukraine have highlighted our heavy dependence on Chinese production and Russian energy. This dependency will have to be reduced at considerable cost, a situation which has led to an extension of EU's policy of «strategic autonomy» or «strategic sovereignty» beyond its traditional areas of security and defence.

Today, this policy of greater autonomy also encompasses a need to increase the resilience of global supply chains by decreasing dependence on certain foreign products and/or countries, especially «less friendly» ones, as well as a need to defend democratic values in all countries of the Union.

These are lines of action on which the EU works together with the US through instruments such as the Trade and Technology Council, founded in June 2021. In general, this Council is a forum for both regions to find agreement through dialogue for a common commercial and technological agenda, with an approach that supports shared democratic values. In particular, one of the Council's working groups focuses on enhancing the security of global value chains, the vulnerabilities of which were highlighted during the COVID-19 pandemic.

A key question now is whether the EU will continue its more moderate approach to its relations with the rest of the world (including China) to achieve its goals of strategic autonomy; or whether, on the contrary, it will adopt a more belligerent position, hand in hand with its renewed transatlantic ally. While it is still too early to know the direction this alliance will take, we can begin to see a certain shift towards a greater tolerance for confrontation.

A more confrontational attitude in areas such as technology or trade could have huge negative effects in terms of economic growth in the short and medium term. At the end of the day, we live in a highly globalised world, more than at any other time in history. In the case of the EU economy, for example, dependence on China, or the 'electronics footprint', is now more important than Russia's 'energy footprint'. In the case of the United States, the links with China in the electronics sector and machinery are even deeper than those of the EU with the Asian giant.

Yet it bears asking that if a confrontational position may have deeply undesirable effects on economic activity, what might a limp response by the West to the current siege of the liberal and democratic order mean for the future of our liberal and democratic political model?

Chronology

OCTOBER 2022

5 OPEC agrees to cut crude oil production by 2 million barrels a day compared to August 2022 levels.
23 Xi Jinping receives a third term as general secretary of the Chinese Communist Party.
27 The ECB raises official interest rates by 75 bps.

SEPTEMBER 2022

8 Queen Elizabeth II dies after a 70-year reign.
16 The death of Mahsa Amini sparks a wave of mass protests in Iran.
27 Sabotage on the Nord Stream 1 and 2 gas pipelines.
30 The European Council approves measures to reduce energy demand.

AUGUST 2022

Summer 2022 Heat waves and drought in Europe and other countries around the world.
Summer 2022 Disruptions in the supply of Russian energy to Europe.
31 Mikhail Gorbachev, the last president of the USSR, dies.

JULY 2022

7 Boris Johnson resigns as prime minister of the United Kingdom.
8 Assassination of Shinzō Abe, former Japanese prime minister.
28 Mario Draghi resigns as prime minister of Italy.

JUNE 2022

26 G7 summit in Germany where the war in Ukraine and energy were top of the agenda.
28 NATO summit in Madrid where Russia is identified as the greatest direct threat.
30 Russia makes gains in establishing control of the Donbas.

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.

Agenda

NOVEMBER 2022

1-2 Federal Open Market Committee meeting.
3 Spain: registration with Social Security and registered unemployment (October).
Portugal: new lending (September).
4 Spain: industrial production (September).
9 Portugal: employment (Q3).
15 Japan: GDP (Q3).
17 Portugal: coincident indicators (October).
18 Portugal: Moody's rating.
25 Spain: loans, deposits and NPL ratio (September).
29 Spain: CPI flash estimate (November).
Euro area: economic sentiment index (November).
30 Spain: state budget execution (October).
Portugal: GDP breakdown (Q3).
Portugal: CPI flash estimate (November).

DECEMBER 2022

2 Spain: rating Fitch.
Spain: registration with Social Security and registered unemployment (November).
Portugal: industrial production (October).
13-14 Federal Open Market Committee meeting.
15 Governing Council of the European Central Bank meeting.
15-16 European Council meeting.
16 Spain: quarterly labour cost survey (Q3).
23 Spain: quarterly national accounts (Q3).
Spain: loans, deposits and NPL ratio (October and Q3).
Spain: balance of payments and NIIP (Q3).
Spain: state budget execution (November).
Portugal: home prices (Q3).
Portugal: household savings rate (Q3).
29 Portugal: NPL ratio (Q3).
30 Spain: CPI flash estimate (December).
Spain: household savings rate (Q3).
Portugal: CPI flash estimate (December).

Inflection points

The world economy is undergoing a phase of transition from the resilience that growth continued to show during the summer months to the strong downward adjustment of activity anticipated by the rapid deterioration of economic sentiment (especially marked in October) and the worsening of financial conditions. There are several risks which could further move the needle, including covid-zero policies in China and geopolitical tensions.

The key for the coming months will be to definitively turn the corner on inflation, seeing off the most aggressive interest rate rises in the last 40 years and reducing volatility in the financial markets. Meanwhile, there is not much news other than generally negative surprises that continue to accumulate (with exceptions like Spain), including increasing prices in the Economic and Monetary Union of 10.7% in October, and the worsening of inflation in countries such as Portugal (10.2%), Germany (11.6%), Italy (12.8%) and the Netherlands (16.8%). Almost two years after the start of the inflationary process, we continue to see new monthly highs, while the various supply shocks have filtered through across the board, as evidenced by the fact that almost 60% of the CPI basket (45% in the case of core inflation) shows annual price growth above 5% in the euro area. More importantly, we are far from understanding the changes in inflation and their potential medium-term implications for growth, equilibrium interest rates, and so on.

In the short term, some signs of decreasing transport costs (of shipping containers, etc.) and the recovery of inventories may be anticipating a gradual dilution of bottlenecks and therefore improvements in the early stages of the price formation process, precisely where problems started to emerge two years ago. In addition, the 2023 gas price futures market has fallen by 25% in recent weeks, reflecting progress in energy policy responses in Europe and the high levels reached by gas reserves (95% of storage capacity).

In other words, we should not be far from the turning point in general inflation in industrialised countries, as the improvement in supply-side constraints will be accompanied by an intense cooling of activity forecast for the next six months. The big unknown will be the pace at which prices return to within the central bank's target bands. Inflation expectations accounted for by financial markets anticipate that inflation could dip below 5% from next summer in Europe and the US, but according to these readings we will have to wait almost two years more to see it approach 2% in Europe. That is, the first part of the journey to reducing inflation could be completed in the next 6 months, but the process would become slower from then on, taking into account structural factors such as deglobalisation, geopolitical risk and the energy transition This may test the tolerance of monetary authorities for deviations of one or two percentage points from the target, especially if there is a high price to pay in terms of employment or financial stability. This will naturally reopen the debate on the appropriateness of targets set in an economic context that is very different from today's.

For now, after the doubts of 2021, global interest rates have increased by 3 percentage points in 2022, mostly in an already restrictive zone. The question that arises now is what effect this sudden monetary tightening will have on activity and employment in the short term, given that the way monetary policy is transmitted to real variables may also be changing. This is why, we can expect a moderation in the intensity of interest rate hikes from here on, which will have to be appropriately combined with balance sheet reduction programmes in an environment of jittery financial markets. The most important thing will be to fully understand the factors behind the sudden rise in inflation, to monitor the path of normalisation towards the target, and to try to anticipate whether we will see a change in price behaviour after the storm. And, more than anything, to avoid unnecessary and painful reactions.

Paula Carvalho

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

Financial markets

	Average 2000-2007	Average 2008-2019	2020	2021	2022	2023	2024
INTEREST RATES							
Dollar							
Fed funds (upper limit)	3.43	0.81	0.25	0.25	4.50	4.75	3.50
3-month Libor	3.62	1.01	0.23	0.21	4.75	4.75	3.50
12-month Libor	3.86	1.48	0.34	0.52	4.90	4.50	3.50
2-year government bonds	3.70	1.04	0.13	0.62	4.20	4.00	3.00
10-year government bonds	4.70	2.57	0.93	1.45	3.80	3.50	3.00
Euro							
ECB depo	2.05	0.20	–0.50	–0.50	2.00	2.50	2.00
ECB refi	3.05	0.75	0.00	0.00	2.50	3.00	2.50
€STR	–	–0.54	–0.56	–0.58	1.92	2.47	2.17
1-month Euribor	3.18	0.50	–0.56	–0.60	2.03	2.53	2.23
3-month Euribor	3.24	0.65	–0.54	–0.58	2.14	2.59	2.29
6-month Euribor	3.29	0.78	–0.52	–0.55	2.35	2.66	2.40
12-month Euribor	3.40	0.96	–0.50	–0.50	2.56	2.73	2.51
Germany							
2-year government bonds	3.41	0.35	–0.73	–0.69	1.75	2.25	2.25
10-year government bonds	4.31	1.54	–0.57	–0.31	2.00	2.70	2.70
Spain							
3-year government bonds	3.62	1.69	–0.57	–0.45	2.23	2.77	2.80
5-year government bonds	3.91	2.19	–0.41	–0.25	2.47	3.04	3.05
10-year government bonds	4.42	3.17	0.05	0.42	3.30	3.80	3.70
Risk premium	11	164	62	73	130	110	100
Portugal							
3-year government bonds	3.68	3.33	–0.61	–0.64	2.41	3.02	3.08
5-year government bonds	3.96	3.94	–0.45	–0.35	2.70	3.28	3.30
10-year government bonds	4.49	4.68	0.02	0.34	3.35	3.85	3.75
Risk premium	19	314	60	65	135	115	105
EXCHANGE RATES							
EUR/USD (dollars per euro)	1.13	1.26	1.22	1.13	1.00	1.05	1.10
EUR/GBP (pounds per euro)	0.66	0.84	0.90	0.85	0.87	0.86	0.85
OIL PRICE							
Brent ($/barrel)	42.3	80.1	50.2	74.8	95.0	94.0	83.0
Brent (euros/barrel)	36.4	62.5	41.3	66.2	95.0	89.5	75.5

Forecasts

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

International economy

	Average 2000-2007	Average 2008-2019	2020	2021	2022	2023	2024
GDP GROWTH							
Global	4.5	3.3	–3.0	6.0	3.1	2.7	3.3
Developed countries	*2.6*	*1.4*	*–4.4*	*5.2*	*2.4*	*1.0*	*1.6*
United States	2.7	1.7	–2.8	6.0	1.6	1.1	1.7
Euro area	2.2	0.8	–6.2	5.3	3.1	0.2	1.6
Germany	1.6	1.2	–4.1	2.6	1.6	–0.2	1.2
France	2.2	1.0	–7.9	6.8	2.5	0.6	1.5
Italy	1.5	–0.3	–9.1	6.6	3.4	–0.2	1.1
Portugal	1.5	0.5	–8.3	5.5	6.3	0.6	2.3
Spain	3.7	0.6	–11.3	5.5	4.5	1.0	1.9
Japan	1.4	0.4	–4.6	1.7	1.5	1.7	1.2
United Kingdom	2.6	1.3	–9.3	7.4	3.5	–1.3	–0.4
Emerging and developing countries	*6.5*	*4.9*	*–1.9*	*6.6*	*3.5*	*4.0*	*4.5*
China	10.6	8.0	2.2	8.1	3.0	5.2	5.0
India	7.2	6.8	–6.7	9.0	7.3	6.0	6.7
Brazil	3.6	1.6	–3.9	4.6	1.8	0.9	1.8
Mexico	2.4	1.9	–8.1	4.8	1.9	1.4	2.5
Russia	7.2	1.3	–2.7	4.8	–8.1	–3.2	3.0
Turkey	5.5	4.5	1.9	11.4	3.1	3.0	3.2
Poland	4.2	3.6	–2.1	6.0	5.6	2.6	3.4
INFLATION							
Global	4.1	3.7	3.2	4.7	8.6	6.0	4.1
Developed countries	*2.1*	*1.6*	*0.7*	*3.1*	*7.1*	*4.0*	*2.0*
United States	2.8	1.8	1.3	4.7	8.0	3.4	2.0
Euro area	2.2	1.4	0.3	2.6	8.1	5.1	2.1
Germany	1.7	1.4	0.4	3.2	8.2	5.2	2.2
France	1.9	1.3	0.5	2.1	5.9	4.1	2.0
Italy	2.4	1.4	–0.1	1.9	7.7	4.8	2.0
Portugal	3.1	1.1	0.0	1.3	7.9	5.7	2.2
Spain	3.2	1.3	–0.3	3.1	9.1	4.5	2.3
Japan	–0.3	0.4	0.0	–0.2	2.2	1.9	1.0
United Kingdom	1.6	2.3	0.9	2.6	8.9	5.5	2.3
Emerging countries	*6.7*	*5.6*	*5.1*	*5.9*	*9.7*	*7.4*	*5.6*
China	1.7	2.6	2.5	0.9	2.0	1.9	1.6
India	4.5	7.3	6.6	5.1	6.6	5.3	5.0
Brazil	7.3	5.7	3.2	8.3	10.5	5.1	4.0
Mexico	5.2	4.2	3.4	5.7	7.2	4.7	3.8
Russia	14.2	7.9	3.4	6.7	14.7	7.5	6.8
Turkey	22.6	9.6	12.3	19.6	69.3	36.4	29.0
Poland	3.5	2.0	3.7	5.2	11.2	7.0	3.7

Forecasts

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

Portuguese economy

	Average 2000-2007	Average 2008-2019	2020	2021	2022	2023	2024
Macroeconomic aggregates							
Household consumption	1.7	0.5	–6.9	4.7	5.0	0.5	2.0
Government consumption	2.3	–0.3	0.4	4.6	2.0	–0.2	–0.2
Gross fixed capital formation	–0.4	–0.7	–2.2	8.7	1.7	3.8	8.4
Capital goods	3.2	2.6	–5.4	13.9	–	–	–
Construction	–1.5	–2.6	1.0	5.5	–	–	–
Domestic demand (vs. GDP Δ)	1.3	0.1	–5.3	5.8	4.0	0.9	2.9
Exports of goods and services	5.3	4.0	–18.8	13.5	16.5	4.3	6.6
Imports of goods and services	3.6	2.7	–11.8	13.3	10.1	5.0	7.8
Gross domestic product	**1.5**	**0.5**	**–8.3**	**5.5**	**6.3**	**0.6**	**2.3**
Other variables							
Employment	0.4	–0.5	–1.9	2.8	1.6	–0.3	0.5
Unemployment rate (% of labour force)	6.1	11.4	7.0	6.6	5.9	6.4	6.1
Consumer price index	3.1	1.1	0.0	1.3	7.9	5.7	2.2
Current account balance (% GDP)	–9.2	–2.9	–1.2	–1.1	–2.7	–2.3	–1.7
External funding capacity/needs (% GDP)	–7.7	–1.6	0.1	0.7	2.1	2.1	2.3
Fiscal balance (% GDP)	–4.6	–5.1	–5.8	–2.9	–1.5	–1.3	–0.7

Forecasts

Spanish economy

	Average 2000-2007	Average 2008-2019	2020	2021	2022	2023	2024
Macroeconomic aggregates							
Household consumption	3.6	0.0	–12.4	6.1	–0.1	–0.7	2.5
Government consumption	5.0	1.1	3.5	2.9	–1.3	1.0	0.7
Gross fixed capital formation	5.6	–1.4	–9.7	0.9	5.1	1.8	2.0
Capital goods	4.9	0.1	–13.3	6.3	5.0	–1.3	3.0
Construction	5.7	–2.9	–10.2	–3.7	4.9	3.9	1.4
Domestic demand (vs. GDP Δ)	4.6	–0.2	–8.6	4.3	0.7	0.2	1.9
Exports of goods and services	4.7	2.9	–19.9	14.4	18.5	2.6	1.9
Imports of goods and services	7.0	0.2	–14.9	13.9	7.0	0.7	2.0
Gross domestic product	**3.7**	**0.6**	**–11.3**	**5.5**	**4.5**	**1.0**	**1.9**
Other variables							
Employment	3.2	–0.4	–6.8	6.6	3.2	0.5	1.4
Unemployment rate (% of labour force)	10.5	19.5	15.5	14.8	12.8	13.1	12.8
Consumer price index	3.2	1.3	–0.3	3.1	9.1	4.5	2.3
Unit labour costs	3.0	0.6	7.7	0.3	0.5	3.2	2.1
Current account balance (% GDP)	–5.9	–0.3	0.6	1.0	0.5	1.3	1.6
External funding capacity/needs (% GDP)	–5.2	0.1	1.1	1.9	1.5	2.3	2.5
Fiscal balance (% GDP)[1]	0.3	–6.5	–10.3	–6.9	–4.5	–4.3	–3.6

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

Forecasts

Weeks of ups and downs in the financial markets

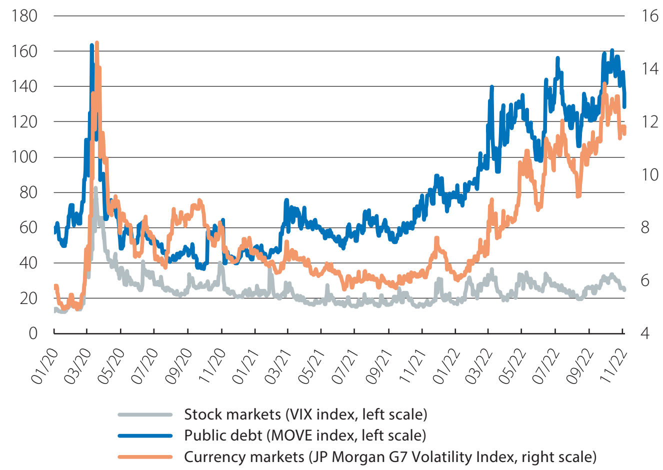
October: a negative first half; a positive second half. Q4 began with a continuation of the tone of volatility and uncertainty in the financial markets, albeit with an improvement during the course of October. The first few weeks of the month were marked by a renewed tightening of financial conditions, driven by signs of persistent inflationary pressures, escalating geopolitical tensions and the crisis triggered by the announcement of a fiscal stimulus plan in the United Kingdom. Subsequent sessions saw a marked improvement in investor sentiment, allowing the main risk assets to close October with gains. Among other factors, the optimism of the second half of the month was driven by the possibility that, in light of the marked slowdown reflected in the economic data, the central banks might decide to reign in the pace of their rate hikes. However, this prospect faded after the Fed's meeting in the US in early November.

United Kingdom, in the eye of the storm. The resolution of the political crisis in the UK was also a factor favouring risk appetite in the second half of October. The financial markets welcomed Rishi Sunak's election as prime minister, and in particular his decision to keep Jeremy Hunt as Chancellor. Expectations that the new government would remain on the path of fiscal rectitude, following the cancelation of the measures announced by the recently deposed Liz Truss, allowed most of the losses in the pound sterling and British bonds to be recovered. In our view, this episode of financial stress in the United Kingdom serves as a warning that, in a context of tightening monetary policy, the margin for manoeuvre of fiscal policy will once again be heavily influenced by the scrutiny of the financial markets (see the Focus «Stormy waters in the UK, a warning to seafarers» in this same report).

The ECB maintains the pace of its rate hikes and assesses its balance sheet reduction strategy, which will be discussed at the upcoming December meeting according to President Christine Lagarde. Thus, the official rate on the deposit facility increased in October by 75 bps to 1.50%. Lagarde confirmed that the next adjustments will be decided upon meeting by meeting and on the basis of the economic data. In addition, the ECB decided to change the conditions applicable to TLTROs beginning in November. Overall, the dovish tone of the last meeting led to a downward revision in implicit rates in the money markets and a decline in sovereign debt yields, although these movements were partially reversed at the beginning of November. In Italy, the risk premium has fallen to around 210 bps (on 4 November), following the formation of the new government under Giorgia Meloni, who confirmed the intention not to deviate from the reform programme agreed with Brussels. Another positive factor

Implicit volatility in the financial markets

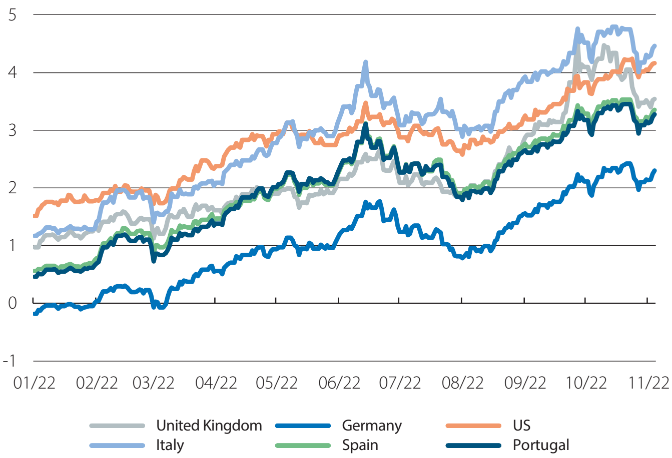
Index *Index*



Note: *Data as of 4 November.*
Source: *BPI Research, based on data from Bloomberg.*

Yield on 10-year sovereign debt

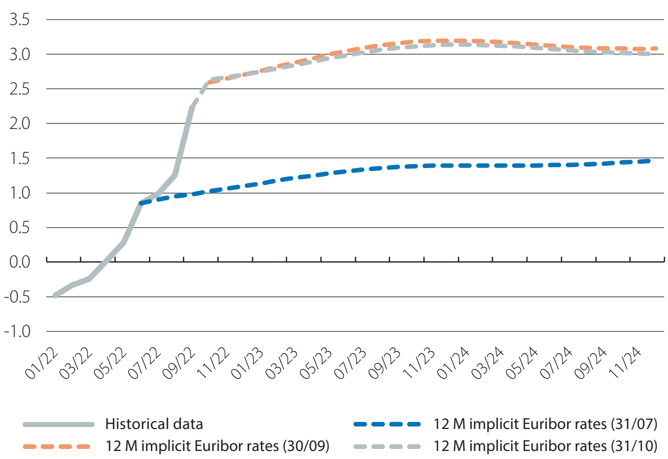
(%)



Note: *Data as of 4 November.*
Source: *BPI Research, based on data from Bloomberg.*

12-month Euribor, historical data and implicit rates in the money markets

(%)



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

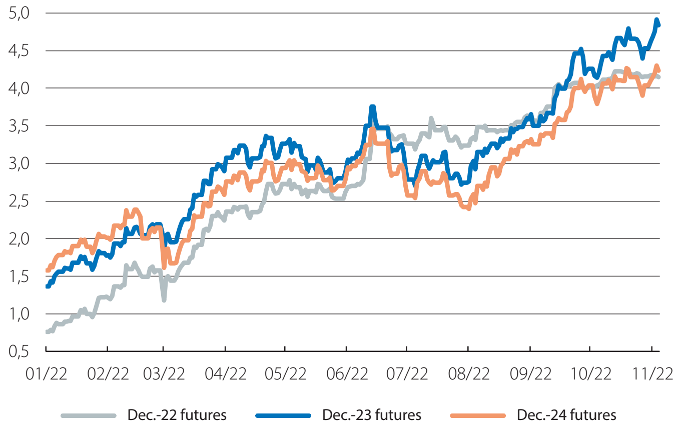
for peripheral debt was the announcement that the German government would be in favour of a new loan fund financed with EU debt.

The Fed also raised rates by 75 bps, although it anticipates a slower pace of rate hikes going forward. At its meeting in early November, the central bank decided to maintain the pace of its rate hikes in order to place the official interest rate in the 3.75%-4.00% range. In his his official statement, the Fed chair Jerome Powell emphasised that the central bank could temper the pace of its rate adjustments as early as December. That said, he also made clear that it is too early to consider a pause in rate hikes and that they will most likely have to raise interest rates above the level envisaged at the September meeting (4.50%-4.75%, according to the dot plot). Other central banks in some advanced countries had already announced lower rate hikes, including in Canada (50 bps to 3.75%), Norway (25 bps to 2.50%) and Australia (25 bps to 2.85%). Meanwhile, the Bank of Japan reiterated its intention to maintain the ultra-accommodative bias in its monetary policy, accentuating the yen's weakness against the dollar.

(Temporary) rally in the euro and equities, except in China. The increased risk appetite in the second half of October was reflected in a weakening of the US dollar, which ended October almost at parity with the euro. However, this pattern was reversed in early November after the Fed's meeting. The equity indices, meanwhile, shortened the declines registered so far this year. In addition to the aforementioned factors, these assets found support in the corporate earnings season which, with the exception of some sectors (such as technology), did not deviate far from the expectations of the consensus. The exception was China: the benchmark stock market indices in Shanghai and Hong Kong registered significant losses in October following a ratcheting up of the authoritarian discourse during the 20th National Congress of the Chinese Communist Party and the deteriorating health situation.

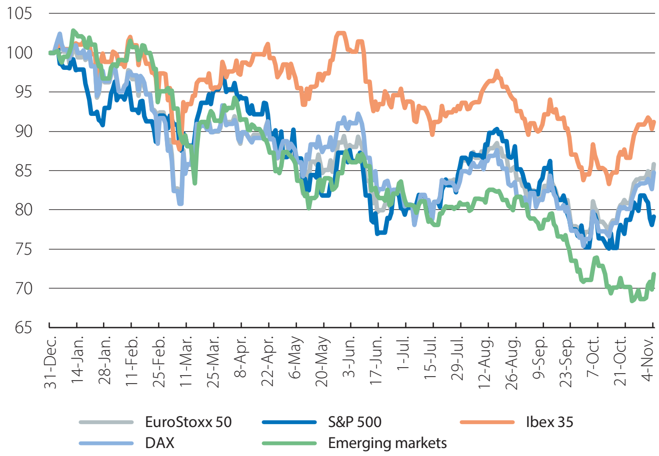
The gas bubble deflates, albeit with ups and downs. Favourable weather in the northern hemisphere, the increase in gas inventories in Europe (up to 95% of total reserve capacity), as well as an increase in the supply of liquefied natural gas from the US favoured a reduction in European gas prices (the Dutch TTF) to four-month lows at the end of October, although this trend reversed slightly at the beginning of November. The implementation of measures to cut usage in most EU countries, coupled with progress in the negotiations to establish a cap on the price of gas, also contributed to this correction. The price of a barrel of Brent oil, in contrast, ended October around 10% up, despite remaining highly volatile. In addition to the easing of the exchange rate against the dollar, the prospect of a possible relaxation of the zero-COVID policy in China improved the outlook for future crude oil demand, in a context marked by production cuts by oil-producing countries and as the date for the application of the EU embargo on Russian oil in December draws closer.

Federal Reserve benchmark interest rate futures
(%)



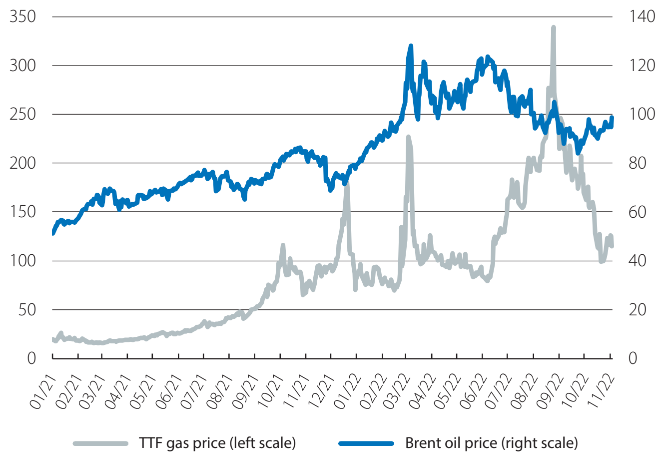
Note: *Data as of 4 November.*
Source: *BPI Research, based on data from Bloomberg.*

Main stock market indices
(100 = 31 December 2021)



Note: *Data as of 4 November.*
Source: *BPI Research, based on data from Bloomberg.*

Oil and gas prices
(Euros per MWh) *(Dollars per barrel)*



Note: *Data as of 4 November.*
Source: *BPI Research, based on data from Bloomberg.*

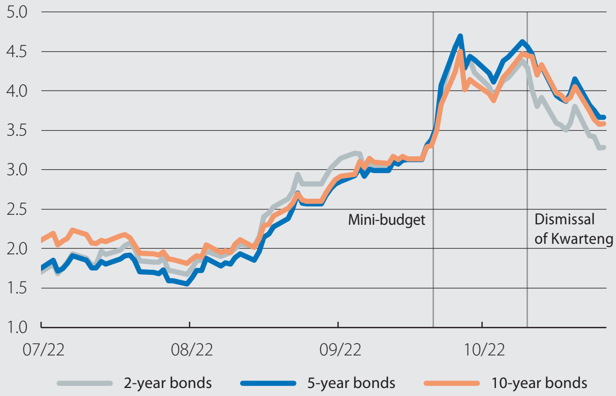
Stormy waters in the UK, a warning to seafarers

An inevitable consequence of the monetary policy normalisation and tightening process is that, after years of anaesthesia through the central banks' battery of stimulus policies, the markets regain some of their power to scrutinise – and thus to discipline – the design and execution of economic policy, both in the monetary sphere and, above all, in the fiscal sphere.

Unsurprisingly, in a context of high volatility and low visibility over the economic scenario, any announcement that raises doubts over the sustainability of public finances or increases the likelihood of default is punished by the «market vigilantes» with heavy losses in the benchmark assets involved – a risk which, in an extreme case, could threaten the stability of the financial system.

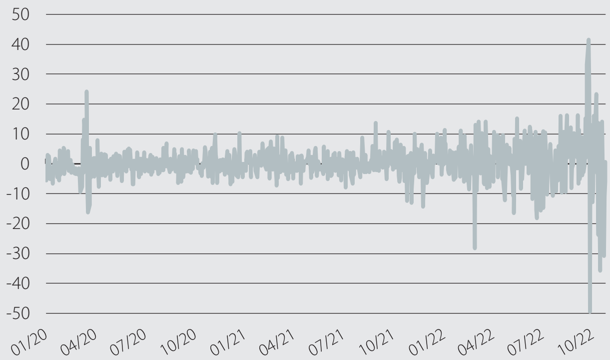
We thus find ourselves in a period of extreme fragility in which, more than ever, it seems essential to avoid any misalignment between fiscal policy and monetary policy in order to minimise the risk of financial panic. The fact that the latest incident of this kind took place in the United Kingdom – a country with deeply liquid markets and whose currency still serves as an international benchmark – serves as a stark warning to seafarers that the seas are rough and the skies are clouded.

United Kingdom: yields on government bonds
(%)



Note: *Data as of 27 October.*
Source: *BPI Research, based on data from Bloomberg.*

United Kingdom: day-to-day change in sovereign debt yields
(bps)



Notes: *Yield on 10-year bonds. Data as of 27 October.*
Source: *BPI Research, based on data from Bloomberg.*

The United Kingdom and its short-lived fiscal stimulus

The Growth Plan of the (former) prime minister Liz Truss, announced in the September mini-budget, aimed to tackle the crisis caused by rising energy costs by approving the biggest tax cut in the country's history: 146 billion pounds up to 2027. This figure would be achieved mainly by cancelling the already-announced rise in corporation tax to 25% (currently at 19%, well below the OECD average of 23.5%) and by cutting the rate applicable in some personal income tax brackets. It also proposed cancelling the increase in national insurance (social security) contributions approved by Boris Johnson's cabinet. In addition, the plan included additional specific measures aimed at mitigating the impact of the rise in energy bills: the Energy Bill Relief Scheme, up until March 2023, and the Energy Price Guarantee, up until 2024.[1]

All in all, the fiscal strategy aimed to raise the trend growth of the British economy to 2.5%, from the 1.5% registered in recent years. Its Achilles heel, however, was that it failed to set out compensatory measures to counter the potential deterioration in the fiscal metrics. Indeed, the UK's Institute for Fiscal Studies warned that the debt-to-GDP ratio would increase to concerning levels and could even exceed 94% of GDP by 2027, compared to 84% in 2021.[2] In addition, the targeted measures aimed at addressing the rising energy prices would push the budget deficit to above 9.0% of GDP in the 2022-2023 fiscal year (versus the 4.0% estimated by the Office for Budget Responsibility in April).

Doubts about the Truss cabinet's commitment to the stability of the public finances, coupled with fears that inflation could soar, led to a sharp negative reaction from the financial markets: the pound slumped to its lowest value against the dollar since the 1980s, while debt securities fell so spectacularly that there were even fears over the stability of private pension funds, which were

1. Households' energy bills would be limited to 2,500 pounds a year up until 2024, which could cost around 100 billion over the next two years.

2. See (2022). «Reversing NICs and corporation tax rises would leave debt on an unsustainable path». The Institute for Fiscal Studies, September.

forced to dump assets in order to meet margin calls and sure up their asset portfolios (see first and second charts). Against this backdrop, the Bank of England was forced to intervene by announcing a government bond-buying programme with no limit in value, but with a cut-off date of 14 October, although this still failed to allay fears over the stability of the medium-term bond markets.

The insurmountable pressure from the markets, coupled with criticism of the plan from institutions such as the IMF, forced a change of course: Kwasi Kwarteng, the Chancellor of the Exchequer behind the plan, was sacked in mid-October, and his replacement, Jeremy Hunt, presented a proposal which reversed 113 billion of the 146 billion in tax cuts initially announced.

This U-turn helped calm the markets and allowed the central bank to return to its monetary policy normalisation strategy. However, the reputational damage was done and Liz Truss herself was compelled to resign, making her tenure as prime minister the shortest in British history. Her recently elected replacement, Rishi Sunak, opted to keep Jeremy Hunt as chancellor and endorsed the strategy of greater fiscal belt-tightening, although the true size of the fiscal gap remains unclear in the face of the deteriorating economic outlook and rising financing costs.

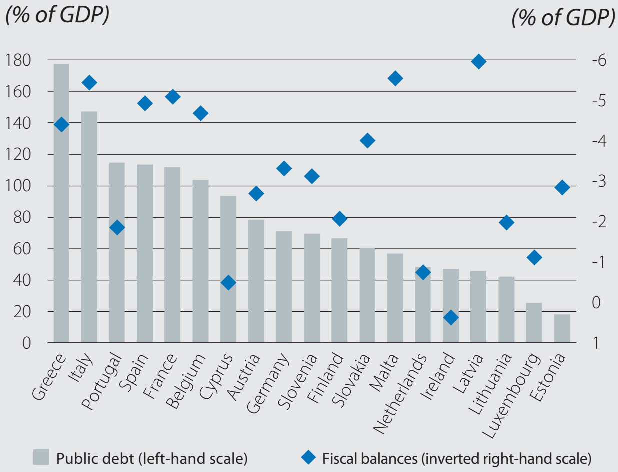
Europe, the weakest link among advanced economies

Putting emerging markets aside, in advanced economies the risks of a British-style financial turmoil tend to be higher in those countries which have greater external financing needs (reflected in current-account deficits), a less robust fiscal position (see third chart) and a less favourable economic growth outlook.

Among these, some European countries look particularly vulnerable, as they face the energy crisis with a marked upturn in inflation, public accounts that are exhausted by the pandemic, and a particularly weak economic outlook in a context of global economic cooling.

Since October last year, governments have been implementing various measures aimed at protecting households and businesses, which we estimate represent around 5.0% of GDP to date on average for the euro area, albeit with significant differences from country to country. Nevertheless, the deteriorating situation since the summer is putting pressure on them to implement additional measures, which, if done indiscriminately, could prove counter-productive. It is not unreasonable to imagine that excessively expansionary fiscal measures could exacerbate the inflationary pressures, and this would likely force the ECB to approve more aggressive rate hikes, leading to higher financing costs and a sharper cooling of the economy.

Euro area: public debt and fiscal balance in 2022



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

In this regard, and in line with the IMF's statements in its Fiscal Monitor, the fiscal policies adopted to alleviate the current crisis must be designed so as to interfere as little as possible with the central banks' objective, while also taking into account the vulnerabilities arising from large public debts. Moreover, the measures implemented must be agreed upon by all countries in order to prevent those with greater fiscal room for manoeuvre from adopting more far-reaching measures.[3]

Among euro area countries, Italy remains on investors' radar, as it is currently in the process of forming a new government following the landslide victory of the right-wing coalition, led by the party of Giorgia Meloni. The new cabinet inherits a difficult financial situation: alongside Germany, Italy is one of the countries hardest hit by the cut-off of Russian gas. The country appears to be in recession, after more than a decade of low economic growth.

In this regard, the Meloni administration faces the challenge of implementing measures to alleviate the growing social unrest, but which at the same time can ensure the stability of the fiscal accounts in order to bring public debt, which stood at 150% of GDP in 2021, down over the coming years. It must also keep up with the reform agenda agreed upon by the EU in order to continue receiving EU funds and, implicitly, to continue to enjoy the ECB's protection through its anti-fragmentation TPI instrument, if necessary. *Buona fortuna, Giorgia!*

3. Germany is working on an emergency plan with a budget of some 200 billion euros (over 5.0% of GDP), which has arisen some criticism among its European partners given that, in the absence of a common fiscal tool, the plan increases the risk of fragmentation in the bloc.

Interest rates (%)

	31-October	30-September	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Euro area					
ECB Refi	2.00	1.25	75	200.0	200.0
3-month Euribor	1.70	1.17	53	227.6	227.7
1-year Euribor	2.63	2.56	7	313.1	311.2
1-year government bonds (Germany)	2.08	1.71	37	271.7	276.9
2-year government bonds (Germany)	1.94	1.76	18	255.6	259.0
10-year government bonds (Germany)	2.14	2.11	3	231.9	231.0
10-year government bonds (Spain)	3.23	3.29	–6	266.0	270.4
10-year government bonds (Portugal)	3.15	3.18	–3	268.3	272.3
US					
Fed funds (upper limit)	3.25	3.25	0	300.0	300.0
3-month Libor	4.46	3.75	71	425.1	432.1
12-month Libor	5.45	4.78	67	486.5	509.1
1-year government bonds	4.60	3.93	67	422.6	444.7
2-year government bonds	4.48	4.28	20	375.0	401.7
10-year government bonds	4.05	3.83	22	253.8	244.4

Spreads corporate bonds (bps)

	31-October	30-September	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	114	135	–22	65.7	63.1
Itraxx Financials Senior	123	148	–25	68.4	65.8
Itraxx Subordinated Financials	220	272	–51	112.1	110.1

Exchange rates

	31-October	30-September	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
EUR/USD (dollars per euro)	0.988	0.980	0.8	–13.1	–14.9
EUR/JPY (yen per euro)	146.970	141.880	3.6	12.3	11.0
EUR/GBP (pounds per euro)	0.862	0.878	–1.8	2.5	1.6
USD/JPY (yen per dollar)	148.710	144.740	2.7	29.2	30.4

Commodities

	31-October	30-September	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	549.6	559.5	–1.8	–5.0	–3.3
Brent ($/barrel)	94.8	88.0	7.8	21.9	15.7
Gold ($/ounce)	1,633.6	1,660.6	–1.6	–10.7	–7.7

Equity

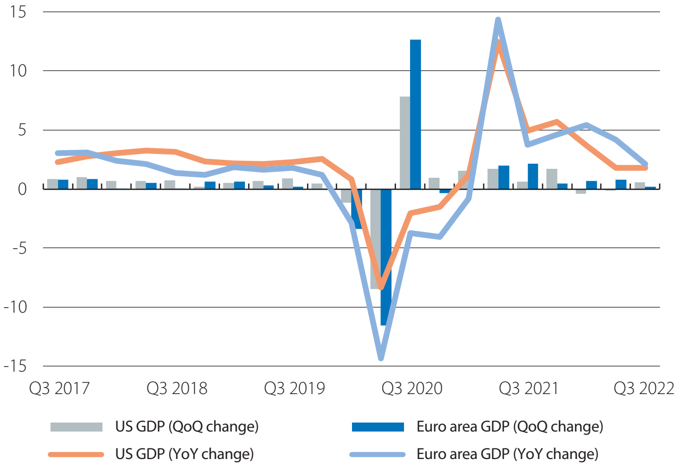
	31-October	30-September	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	3,872.0	3,585.6	8.0	–18.8	–16.9
Eurostoxx 50 (euro area)	3,617.5	3,318.2	9.0	–15.8	–16.1
Ibex 35 (Spain)	7,956.5	7,366.8	8.0	–8.7	–11.9
PSI 20 (Portugal)	5,718.3	5,302.8	7.8	2.7	0.5
Nikkei 225 (Japan)	27,587.5	25,937.2	6.4	–4.2	–6.5
MSCI Emerging	848.2	875.8	–3.2	–31.2	–32.8

Where is the eye of the storm?

The impact of monetary policy and the energy crisis is beginning to be felt in advanced economies. Euro area GDP growth in Q3 2022 was better than expected, but the likelihood of contractions in the coming months is high. Specifically, GDP grew by 0.2% in quarter-on-quarter terms (*vs.* 0.8% in Q2), corresponding to a year-on-year increase of 2.1%. The most positive surprises came from the German economy, which managed to avoid a contraction with 0.3% quarter-on-quarter growth, and from Italy, which registered 0.5% quarter-on-quarter growth in the quarter. This stamina in some of the euro area's biggest economies can be explained by the strong performance of the services sector over the summer. However, although the breakdown by component is not yet available, the main economic activity indicators suggest a declining trend during the course of the quarter. In the US, GDP grew by 1.8% year-on-year and by 0.6% compared to the previous quarter, following two consecutive quarters of decline in Q1 and Q2 (–0.4% and –0.1% quarter-on-quarter, respectively). Although the overall figure was positive, the breakdown by component reveals a slowdown in private consumption and a collapse in property investment. These are two clear signs of weakening domestic demand, in the midst of the strongest cycle of monetary contraction by the Fed in more than 40 years, which has already raised interest rates by a total of 375 bps since March (see the Financial Markets Economic Outlook section).

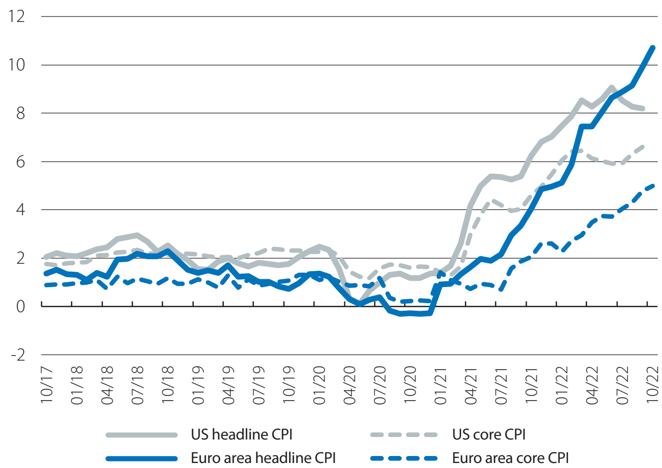
Economic activity experiences a «significant» slowdown in autumn, inflation less so. The first economic activity indicators point towards a clear deterioration in the economic situation beginning in September. In the euro area, where the ECB has already raised interest rates by a total of 200 bps since July, with two consecutive 75-bp rate hikes in September and October, the composite business PMI continued to fall, reaching 47.3 points (*vs.* 48.1 in September). This marks its lowest level in almost two years and is consistent with a steady loss of buoyancy since Q2. In the words of ECB President Christine Lagarde, economic activity is showing a «significant» slowdown, which may intensify with the loss of households' purchasing power and deteriorating confidence. In the US, the composite PMI fell back down to 48.2 points in October, after a brief improvement in September (49.5 points *vs.* 44.6 in August). Although in the case of the US the ISM indices were still in expansionary territory (above 50 points), the fact is that they have also deteriorated. Meanwhile, inflation is still showing no sign of abating. In the euro area, it rose once again in October, reaching 10.7% (*vs.* 9.9% in September), driven by price increases in food, energy and industrial goods. September's inflation figure was also higher than expected in the US, with a sharp month-on-month increase in the core index, which stood at 6.6% year-on-year (8.2% for the headline index). Taken together, with the strength still demonstrated by the labour market on both sides of the Atlantic and the inertia of some of these price components, these figures may be a sign

US and euro area: GDP
(%)



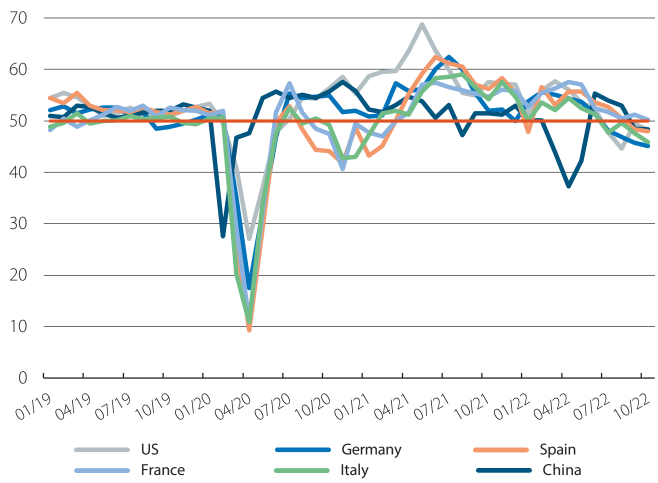
Source: *BPI Research, based on data from the Bureau of Economic Analysis and Eurostat.*

US and euro area: CPI
Year-on-year change (%)



Source: *BPI Research, based on data from the Bureau of Labor Statistics and Eurostat.*

Global: composite PMI
Level



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

that a longer period of high prices and restrictive monetary conditions lies ahead.

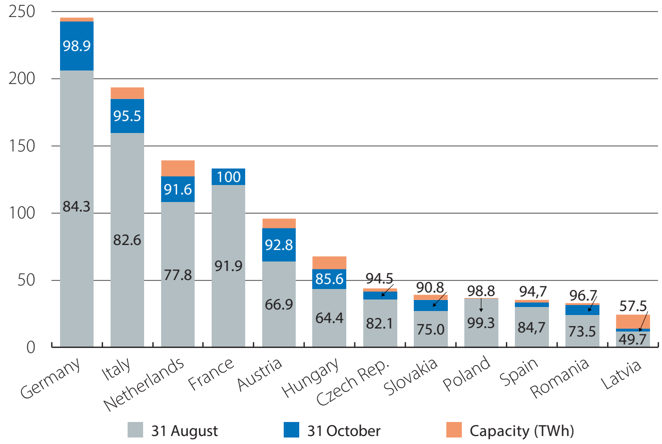
The European energy market remains calm while the weather and reserves allow it. The average gas futures price for 2023 fell by 18% in October (€155/MWh *vs.* €189/MWh in September) in the Dutch TTF, the market that serves as the main benchmark for Europe. Despite being seven times above the historical average, the decline in prices was mainly due to the high level of reserves, which stood at 95% of capacity at the end of October, compared to 80% at the end of August. In this context, in recent weeks there have been reports of LNG carriers waiting to unload at the main European ports. This situation of an easing of prices and oversupply may, however, be temporary. Two key variables to follow are the reductions in consumption achieved by EU countries and the level of reserves. With no end in sight for the war in Ukraine, the 2023-2024 winter will also be to play for over the coming months.

Macrofinancial risks, fiscal policies and the real estate market. As the slowdown in the global economy and the tighter monetary policies persist for longer than expected, it will be particularly important to keep an eye on national fiscal plans and the real estate market. In the euro area, home prices have risen by 20% compared to the pre-pandemic level (Q4 2019), with gains of around or even greater than 30% in many countries. In the US, the rally has been close to 40% (see the Focus «US: controlled slowdown or hard landing in the housing market» in this same report), while China continues to face a severe housing crisis and is among the G20 economies where home prices have grown the least over this period. Another source of macrofinancial risk will be fiscal policy, in both emerging and advanced economies. As the recent turbulence in the markets and the political crisis in the United Kingdom have demonstrated, there will be zero tolerance for fiscal plans with «the shelf-life of a lettuce» (see the Focus on «Stormy waters in the UK, a warning to seafarers» in this same report). The public accounts of countries with newly elected governments will be under intense scrutiny: presidents Giorgia Meloni and Lula da Silva should take note.

In China, will the short-term prosperity last in the long term? China's GDP was higher than expected in Q3 2022, with 3.9% growth versus Q2 (3.9% year-on-year as well), thus more than recovering from the crash registered in Q2. However, the strength of the recovery seems to have tempered in autumn. The data already available for October indicate a marked deterioration in the services sector, following the surge in cases and new lockdowns imposed in the country, as well as a slowdown in exports. The weakness of the Chinese economy could intensify in the coming months, as a result of the intermittent stops and starts imposed due to the zero-COVID policy and the cooling of global demand. In the medium term, the main messages coming out of the 20th National Congress of the Chinese Communist Party have been clear: security and self-sufficiency will be undisputed priorities. It remains to be seen how the new policy direction will materialise in the development of the domestic market and foreign policy.

Europe: gas reserves

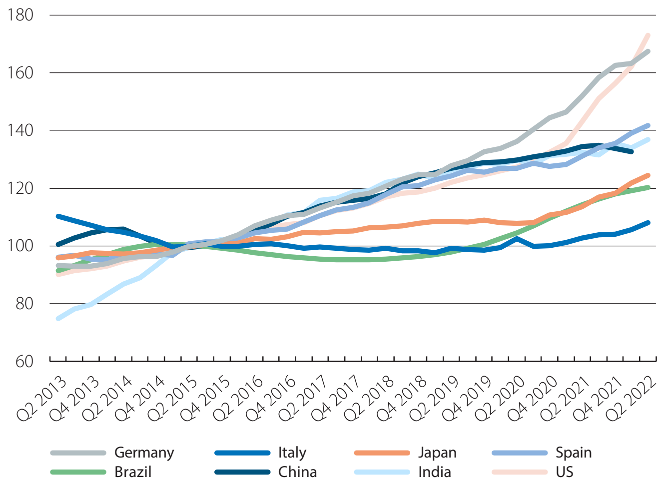
Storage level (TWh and % of total capacity)



Note: *Gas reserves as of 31 October. The chart shows the sum of the percentages corresponding to the storage levels at each date relative to each country's total capacity.*
Source: *BPI Research, based on data from Gas Infrastructure Europe.*

Global: home prices

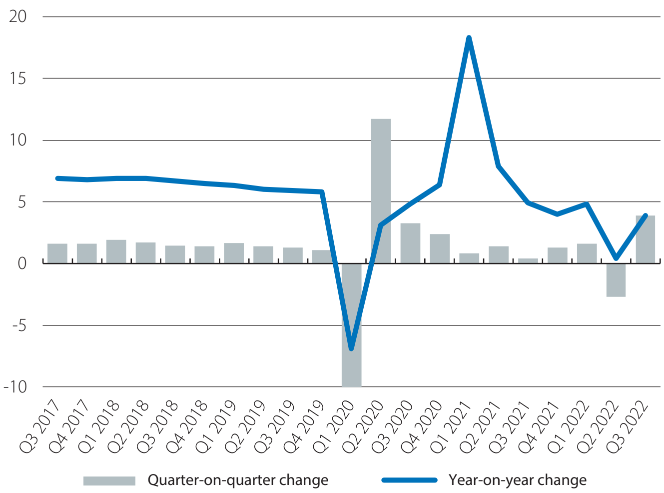
Index (100 = 2015)



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

China: GDP

Change (%)



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

US: controlled slowdown or hard landing in the housing market?

The tightening shift in the Fed's monetary policy in an attempt to combat inflation already seems to be having a negative impact on the country's real estate sector. This should come as no surprise: after all, the Fed's intention is precisely to control inflation by cooling demand. And the latter is achieved, in large part, through the real estate channel: higher rates lead to a reduction in the demand for housing, which translates into less construction activity, which in turn indirectly reduces demand for other goods and services. The key question here is: will we see a controlled slowdown or will it be a hard landing?

Recent context: soaring prices and slowdown in sight

Since the outbreak of the pandemic, we have seen a rise in the price of housing in the US. In particular, between February 2020 and August 2022 the increase exceeded 40%, representing an average annual growth rate of 15% in nominal terms. This is extremely high, exceeding even the growth registered in the years leading up to the global financial crisis (GFC), when it stood at around 10% (see first chart).[1]

However, with the rising interest rates, some indicators in the sector have already begun to slow down. This is the case for the number of home sales, which registered double-digit drops in year-on-year terms as early as the summer (see second chart). The rate at which new housing construction projects are being started has also slowed in recent months (with year-on-year declines as well). After all, the interest rate on the average 30-year fixed-rate mortgage stood at around 7% at the end of October, a level not seen since mid-2006, before the financial crisis (see third chart).

More generally, real residential investment has contracted by more than 10% so far this year. These downward pressures on the real estate sector will persist over the coming quarters and will weigh down economic activity, while also helping to reduce inflationary pressures.

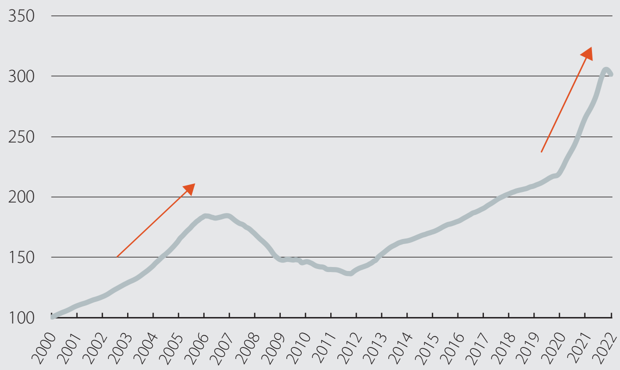
Imbalances and nuances

The sharp rise in home prices in recent years has translated into a clear deterioration in many housing

1. Between January 2000 and June 2006. Case-Shiller US National Home Price Index. Similar results are produced using the Case-Shiller 20-City Composite Home Price Index. In real terms (using the Dallas Fed's home price index), the average annual increase over the past two and a half years has been around 9%, compared to just over 5% before the global financial crisis.

US: home prices *

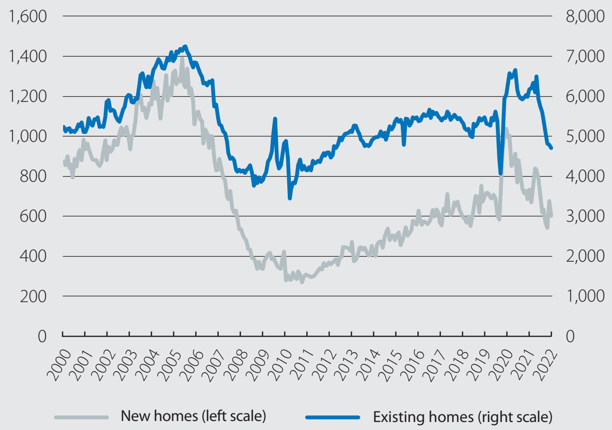
Index (100 = January 2000)



*__Note:__ * Case-Shiller US National Home Price Index. This is a weighted index of repeat sales, which means it corrects for the quality of the homes sold.*
__Source:__ BPI Research, based on data from S&P Case-Shiller, via Refinitiv.

US: home sales

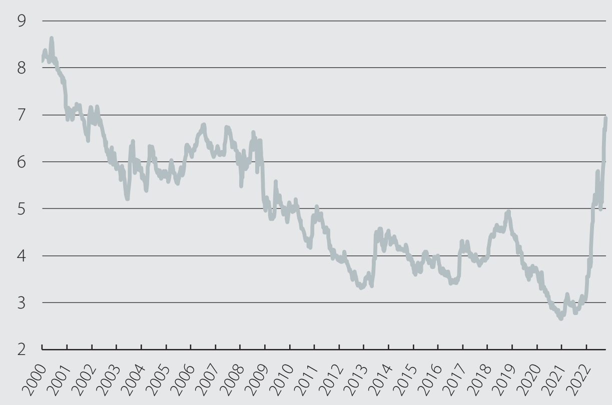
(Thousands of homes) *(Thousands of homes)*



__Source:__ BPI Research, based on data from the National Association of Realtors.

US: 30-year fixed-rate mortgage average

(%)



__Source:__ BPI Research, based on data from the Federal Reserve Bank of St. Louis (FRED), via Refinitiv.

affordability indices. If we look at the evolution of the ratio between home prices and household income (a simple and commonly used measure for capturing households' ability to afford a home), we note that not only is this ratio above the historical average since January 2000, but it also exceeds the levels reached just prior to the global financial crisis (see fourth chart). Similarly, the various models developed by the Dallas Fed, which measure the potential imbalances in real-estate prices in different countries, also place the US market in overheating territory.[2]

That said, there are some elements that clearly differentiate the current environment from the global financial crisis, suggesting that the risk of an episode of financial feedback like the one which occurred at that time is less likely now. For instance, many of the mortgage owners will not be affected by the recent rate hike, since most buyers have purchased their homes at fixed rates, and in recent years those rates have been very low.[3]

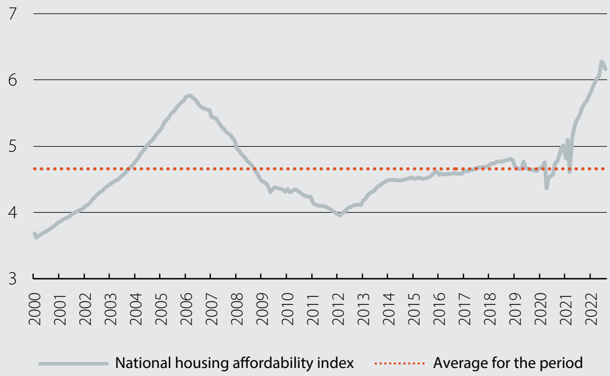
Secondly, the conditions for granting mortgages have been more stringent than in the past, thereby reducing these financial risks. For instance, the Mortgage Credit Availability Index, which captures the stringency of standards in the granting of mortgages, indicates that mortgage approval criteria are currently sound.[4] In the same vein, the Housing Credit Availability Index, which calculates the percentage of mortgaged homes that could go into arrears, is also very low right now.

Finally, another important nuance to bear in mind when considering the current imbalance in prices is the fact that households' finances are in a healthier position now than they were in 2007, with a debt ratio of around 75% of GDP in mid-2022. This is in line with the levels of 2001 and a far cry from the peaks reached in 2007-2008 (around 100% of GDP). Moreover, the current low level of unemployment, which stood at 3.5% in September (a 50-year low in the series, which had been reached just before the outbreak of the pandemic), is an additional element of strength for households' current financial situation.

Continuing with the analysis of the various imbalances that could affect the real estate market, we should mention the shortage of housing supply in the country. For illustrative purposes, the number of single-family homes available for sale is at its lowest level in 40

US: national housing affordability index

*Price over income **



Note: ** Based on median household incomes and home prices measured using the national Case-Shiller index.*
Source: *BPI Research, based on data from the American Community Survey and the National Association of Realtors, via Refinitiv.*

years.[5] This shortage goes beyond the construction delays caused by the recent global supply problems, and is partly due to strict zoning policies in the US which favour the construction of single-family homes, as opposed to buildings with more tenants which would allow for greater supply.

As a result, although the growth in home prices will slow (and possibly fall) in the coming quarters, this adjustment will be less pronounced than we might expect in view of the Fed's rapid and sharp rise in interest rates.

2. Dallas Fed, International House Price Database: https://www.dallasfed.org/institute/houseprice.
3. See R.J. Kish (2022). «The Dominance of the US 30-Year Fixed Rate Residential Mortgage». Journal of Real Estate Practice and Education, 24(1), 1-16.
4. Index produced by the Mortgage Banker Association.
5. According to data from the National Realtor Association: Total inventory single family, which has a historical series beginning in 1982.

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

UNITED STATES

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Activity									
Real GDP	–3.4	5.9	5.7	3.7	1.8	1.8	–	–	–
Retail sales (excluding cars and petrol)	2.1	17.5	16.2	11.2	7.9	8.2	8.0	7.5	...
Consumer confidence *(value)*	101.0	112.7	112.9	108.1	103.4	102.2	103.6	107.8	102.5
Industrial production	–7.2	4.9	4.5	4.8	4.5	4.4	3.9	5.3	...
Manufacturing activity index (ISM) *(value)*	52.5	60.6	60.1	57.8	54.8	52.2	52.8	50.9	50.2
Housing starts *(thousands)*	1,396	1,605	1,679	1,720	1,647	1,461	1,566	1,439	...
Case-Shiller home price index *(value)*	228	267	283	299	314	...	310	...	...
Unemployment rate *(% lab. force)*	8.1	5.4	4.2	3.8	3.6	3.6	3.7	3.5	3.7
Employment-population ratio *(% pop. > 16 years)*	56.8	58.4	59.2	59.9	60.0	60.1	60.1	60.1	60.0
Trade balance [1] *(% GDP)*	–3.2	–3.6	–3.6	–3.9	–4.0	–3.9	–3.9	–3.9	...
Prices									
Headline inflation	1.2	4.7	6.7	8.0	8.6	8.3	8.3	8.2	...
Core inflation	1.7	3.6	5.0	6.3	6.0	6.3	6.3	6.6	...

JAPAN

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Activity									
Real GDP	–4.6	1.7	0.5	0.6	1.6	...	–	–	–
Consumer confidence *(value)*	31.0	36.3	38.3	34.8	33.1	31.2	32.5	30.8	29.9
Industrial production	–10.6	5.6	1.1	–0.6	–3.6	4.0	4.2	9.7	...
Business activity index (Tankan) *(value)*	–19.8	13.8	18.0	14.0	9.0	8.0	–	–	–
Unemployment rate *(% lab. force)*	2.8	2.8	2.7	2.7	2.6	2.6	2.5	2.6	...
Trade balance [1] *(% GDP)*	0.1	–0.3	–0.3	–1.0	–2.0	–4.1	–3.6	–3.9	...
Prices									
Headline inflation	0.0	–0.2	0.5	0.9	2.4	2.9	3.0	3.0	...
Core inflation	0.2	–0.5	–0.7	–0.9	0.8	1.5	1.6	1.8	...

CHINA

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Activity									
Real GDP	2.2	8.1	4.0	4.8	0.4	3.9	–	–	–
Retail sales	–2.9	12.4	3.5	1.6	–4.9	3.5	5.4	2.5	...
Industrial production	3.4	9.3	3.9	6.3	0.6	4.8	4.2	6.3	...
PMI manufacturing *(value)*	49.9	50.5	49.9	49.9	49.1	49.5	49.4	50.1	49.2
Foreign sector									
Trade balance [1,2]	524	680	680	728	822	903	887	903	903
Exports	3.6	30.0	23.1	15.7	12.9	10.0	7.0	5.6	–0.6
Imports	–0.6	30.1	23.7	10.5	1.6	0.9	0.3	0.3	–0.7
Prices									
Headline inflation	2.5	0.9	1.8	1.1	2.2	2.7	2.5	2.8	...
Official interest rate [3]	3.9	3.8	3.8	3.7	3.7	3.7	3.7	3.7	3.7
Renminbi per dollar	6.9	6.5	6.4	6.3	6.6	6.9	6.8	7.0	7.2

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	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Retail sales *(year-on-year change)*	–0.8	5.5	4.2	5.1	0.7	...	–2.0	...	...
Industrial production *(year-on-year change)*	–7.6	9.0	0.3	–0.2	0.4	...	2.5	...	...
Consumer confidence	–14.2	–7.4	–7.5	–13.7	–22.4	–26.9	–25.0	–28.8	–27.6
Economic sentiment	88.3	110.8	116.0	111.2	104.0	96.5	97.3	93.6	92.5
Manufacturing PMI	48.6	60.2	58.2	57.8	54.1	49.3	49.6	48.4	46.4
Services PMI	42.5	53.6	54.5	54.1	55.6	49.9	49.8	48.8	48.6
Labour market									
Employment (people) *(year-on-year change)*	–1.5	1.4	2.4	3.1	2.7	...	–	–	–
Unemployment rate *(% labour force)*	8.0	7.7	7.1	6.8	6.7	...	6.7	6.6	...
Germany *(% labour force)*	3.7	3.6	3.3	3.1	3.0	...	3.0	3.0	...
France *(% labour force)*	8.0	7.9	7.5	7.3	7.6	...	7.3	7.1	...
Italy *(% labour force)*	9.3	9.5	9.0	8.5	8.1	...	7.9	7.9	...
Real GDP *(year-on-year change)*	–6.3	5.5	4.8	5.5	4.3	2.1	–	–	–
Germany *(year-on-year change)*	–4.1	2.8	1.2	3.5	1.7	1.1	–	–	–
France *(year-on-year change)*	–7.9	7.2	5.1	4.7	4.2	1.0	–	–	–
Italy *(year-on-year change)*	–9.1	7.0	6.5	6.4	4.9	2.6	–	–	–

Prices

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

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
General	0.3	2.6	4.6	6.1	8.0	9.3	9.1	9.9	10.7
Core	0.7	1.5	2.4	2.7	3.7	4.4	4.3	4.8	5.0

Foreign sector

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

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Current balance	1.8	2.6	2.6	1.8	0.7	...	–0.1	...	...
Germany	7.0	7.4	7.4	6.6	5.4	...	4.5	...	...
France	–1.8	0.4	0.4	0.1	–0.5	...	–1.0	...	...
Italy	3.9	3.1	3.1	2.1	0.9	...	–0.1	...	...
Nominal effective exchange rate[1] *(value)*	**93.8**	**94.2**	**92.7**	**92.5**	**90.1**	**88.9**	**88.5**	**89.2**	**90.8**

Credit and deposits of non-financial sectors

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

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Private sector financing									
Credit to non-financial firms[2]	6.3	3.5	3.3	4.4	6.1	8.4	8.8	8.9	...
Credit to households[2,3]	3.2	3.8	4.1	4.4	4.6	4.5	4.5	4.4	...
Interest rate on loans to non-financial firms[4] *(%)*	1.2	1.2	1.1	1.2	1.4	1.8	1.6	2.4	...
Interest rate on loans to households for house purchases[5] *(%)*	1.4	1.3	1.3	1.4	1.5	2.1	2.1	2.3	...
Deposits									
On demand deposits	12.9	12.6	10.5	9.1	7.7	6.3	6.8	5.5	...
Other short-term deposits	0.6	–0.8	–1.5	–0.3	0.9	5.3	4.6	8.1	...
Marketable instruments	8.1	11.4	9.2	–0.2	1.3	3.9	2.8	8.2	...
Interest rate on deposits up to 1 year from households *(%)*	0.2	0.2	0.2	0.2	0.2	0.4	0.4	0.6	...

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.*

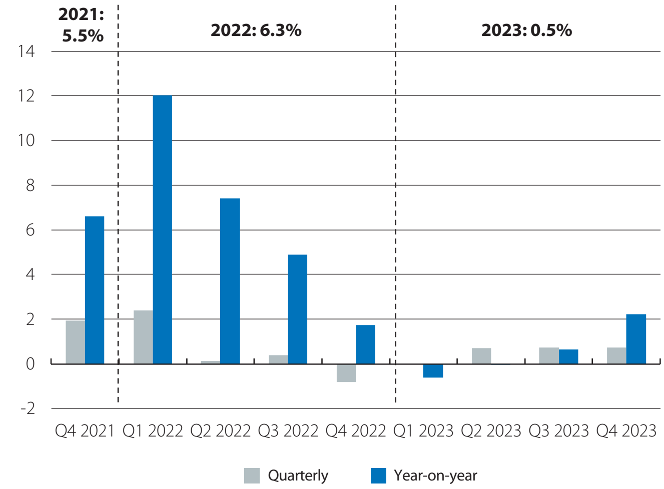
The Portuguese economy resists rising interest rates and inflation

GDP growth has been surprisingly strong, growing at 0.4% quarter-on-quarter and 4.9% year-on-year in Q3 2022, though the latest indicators suggest that the economy could still pull back in Q4. Indeed, the most recent activity indicators available relate essentially to consumption - representing around 65% of GDP - and suggest a less dynamic picture. For example, car sales and ATM payments and withdrawals declined in September. In October, consumer confidence fell to a level close to that recorded during the worst phase of the pandemic, revealing worse prospects for the future evolution of inflation and employment. There is a greater lag on the publication of production indicators, but confidence indicators across sectors show a weakening of sentiment in October and less positive prospects for activity in the coming months. The incorporation of this information in our forecasts leads us to forecast a quarter-on-quarter contraction in GDP in Q4 2022, but does not call into question our forecast of 6.3% growth in 2022 nor change the upward risk bias for growth in 2022. The rubber will really hit the road in 2023, when a strong cooling down is expected, reflecting the negative impacts of higher interest rates and inflation.

Inflation surpasses the 10% barrier in October. The CPI flash estimate shows a year-on-year rate of 10.2%, with a strong year-on-year increase (+1.25%). Unprocessed food (+1.7% quarter-on-quarter) but especially the energy index (+6.7% quarter-on-quarter) continued to drive up prices. In the energy field, a good part of the rise is explained by the revision of tariffs and prices of the regulated market for electricity and natural gas, which came into force in October. Nevertheless, the current high level of reserves in Europe caused Dutch TTF futures to fall below 100 eur/MWh for the first time since June on 24 October. On the food front, the FAO price index continues to show year-on-year rises, albeit more moderate than those seen in the first half of the year. All things considered, our forecast for average inflation of 7.9% in 2022 remains balanced, but with upside risks.

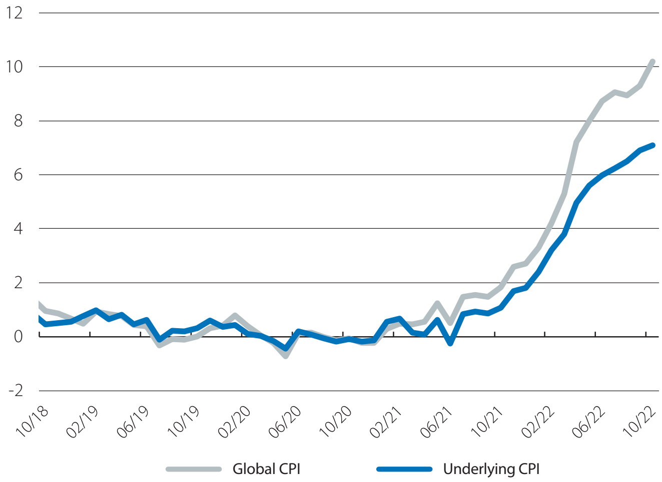
Labour market giving some warning signs. Unemployment registered at job centres rose for the second consecutive month in September. More specifically, it increased by 1.6% in the month, reaching 287,240 individuals. The figure is still well below that recorded before the pandemic (–4.7%, or –14,000 unemployed), but it may signal a change of trajectory in the labour market, which we anticipate to occur in the last quarter of 2022. This increase is largely explained by the Public Administration, education, health and social support sectors (+1,887 unemployed). Another red flag relates to the increase in new unemployment registered in September of more than 57,600 new unemployed people, a higher increase than in September 2019 and 2018, but still lower than in 2016 or 2017. Likewise, job offers in job centres fell for the fourth consecutive

GDP growth
(%)



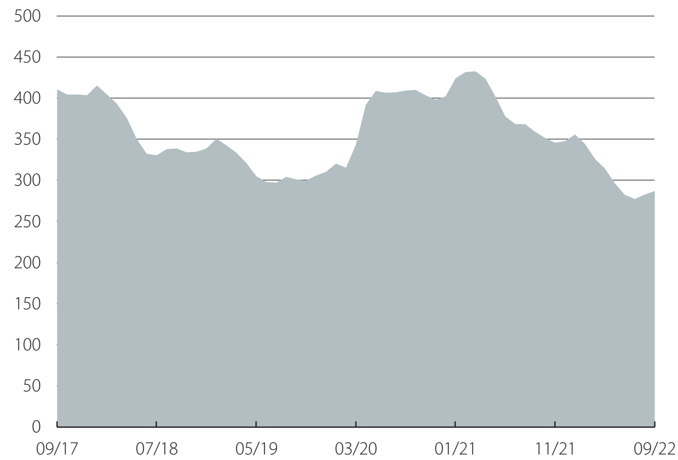
Source: *BPI Research, based on data from the INE (National Institute of Statistics).*

CPI: year on year variation
(%)



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

*Portugal: unemployment as recorded at job centres **
(Thousands of individuals)



Note: ** Non-seasonally adjusted data.*
Source: *BPI Research, based on data from the IEFP (Institute for Employment and Vocational Training.*

month, reaching just over 19,000 offers, a number that still compares positively with pre-pandemic levels (average of 17,000) or those recorded at the beginning of this year (above 16,400).

The budget surplus in September doubled from the previous month. More specifically, the surplus stood at 3.0% of GDP until September (–2.9% year-on-year and +1.6% in the same period of 2019), a movement explained by the substantial increase in revenue (15.5% year-on-year) against a residual increase in expenditure (0.3%). Tax revenue remained the main driver of this considerable improvement, explaining more than 72% of the increase in total revenue. On the expenditure side, the lower interest burden and current and capital transfers offset the increase in expenditure on personnel and the acquisition of goods and services. The risks for this year seem balanced, with the deficit expected to be around 1.5% for the year as a whole. The biggest challenges will take place in 2023, with a slowing economy, rising financing costs, continuing high inflation and geopolitical uncertainty (see Focus in this IM).

New revision to housing price forecasts. Indeed, we have revised the forecast for property valuation in 2022 upwards (to 11.7%) and downwards for 2023 (to –1.5%) and for 2024 (0.6%). The strong Q2 2022 HPI data together with those of Confidencial Imobiliário's Residential Price Index continue to signal solid appreciation in Q3. The outlook is not so optimistic for next year: the sharp rise in euro reference rates will make financing more expensive and the expectations of various agents with regard to prices and the number of transactions are coming close to entering negative territory. It is already possible to see a strong deceleration in the volumes of housing loans being contracted. We believe that the erosion of households' disposable income via inflation and the increasing weight of financial expenses will constrain demand and this will be reflected in prices from the end of this year.

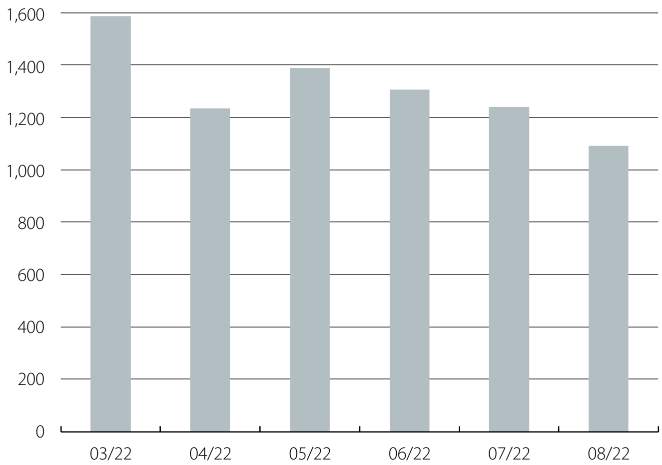
Banks anticipate lower demand for credit by companies and individuals in Q4. The bank lending survey points to a tightening of credit standards, both for companies and individuals (in the case of the latter, particularly for mortgage loans), with a greater perception of the risks regarding the economic situation and, in the case of companies, in some sectors in particular. On the demand side, banks reported a slight decrease in the case of companies and households (with emphasis on the lower demand for housing loans, triggered by lower confidence, a more unfavourable outlook for the real estate market and rising interest rates). For Q4, banks anticipate that credit standards will become more restrictive for companies and households, in a context where they expect a reduction in the demand for credit by companies (especially in the case of large companies and longer loans) and households (mainly in terms of housing loans).Meanwhile, the housing loan portfolio decelerated to 3.3% year-on-year in September (from 3.6% in August), while the stock of NFCs fell again (–0.2%, from –0.3% year-on-year in August).

Budget Execution of the Public Administration (main headings)

January-September (% GDP)	2019	2020	2021	2022	Var. 2022 vs 2019	Var. 2022 vs 2021 (million euros)
Revenue	**40.8**	**40.5**	**40.6**	**42.6**	**1.8**	**10,126**
Tax Revenue	23.9	23.4	22.9	25.0	1.1	7,363
Social Security Contributions	10.2	10.8	10.9	10.8	0.6	1,676
Expenditure	**39.2**	**44.1**	**43.5**	**39.6**	**0.4**	**181**
Personnel expenses	9.6	10.7	10.5	9.8	0.2	443
Current Transfers	17.1	19.8	19.4	17.6	0.5	–187
Acquisition of Goods and Services	5.5	6.0	5.9	5.8	0.3	733
Interest	3.6	3.5	2.9	2.4	–1,2	–443
Investment	1.9	2.2	2.6	2.4	0.5	53
Budgetary Balance	**1.6**	**–3.5**	**–2.9**	**3.0**	**1.4**	**9,945**

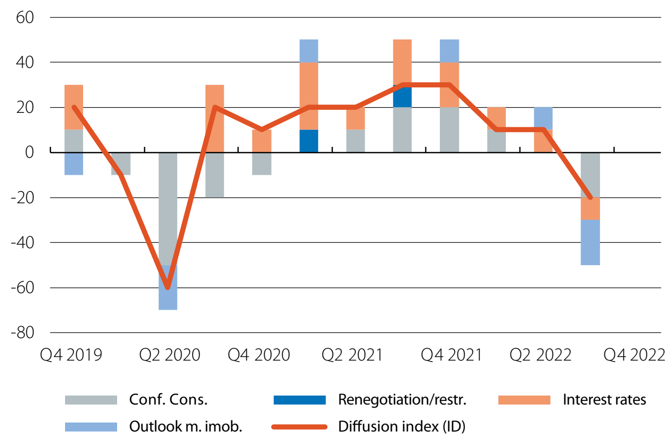
Source: *BPI Research, based on data from the Directorate-General for the Budget.*

New mortgage loan operations
(Billions of euros)



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

*Portugal: diffusion index - demand for mortgage loans **
Value



Note: ** Values lower/higher than 0 indicate a reduction/increase in demand.*
Source: *BPI Research, based on data from the IEFP (Institute for Employment and Vocational Training).*

«*Habemus Pactum*»: agreement on income and competitiveness will be a guideline until 2026

The Government has agreed with Business and Union Groups[1] on a medium-term plan to improve household incomes and business competitiveness. Some of these measures have already been incorporated in the State Budget proposal for 2023, presented in October. In this article we will explore, in a general way, what these objectives seek to achieve.

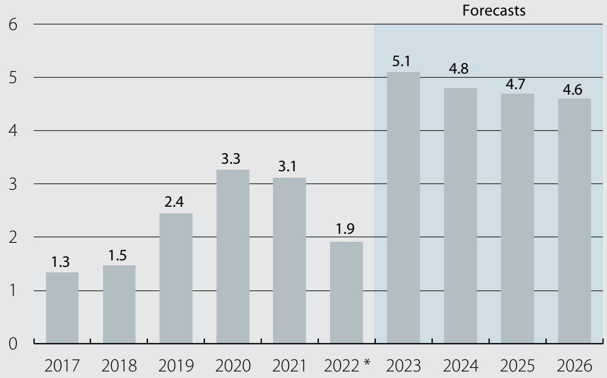
As far as households are concerned, the objectives seem promising, as they may partially offset the adverse effects of price and interest increases and a possible deterioration in the labour market. Regarding salaries, the objective is for their weight in GDP to reach 48.3% in 2026, which represents an increase of 3% compared to 2019. For this, the agreement points to a 20% increase in the average income per worker between 2022 and 2026 and an increase in the Guaranteed Minimum Monthly Remuneration (national minimum wage) to 900 euros by the end of 2026.[2] The first objective may prove challenging:if we use the historical evolution of the average monthly gross basic pay as a reference, compliance with the agreement would require increases substantially higher than those registered in recent years (see first graph). With regard to the national minimum wage, it is possible that with this measure, the share of people receiving a wage equivalent to the minimum wage as part of total employment numbers will continue to rise (as can be seen in the second graph).

In order to increase family liquidity, the agreement also includes updating the personal income tax brackets by 5.1%, mentions an intention to ensure the fiscal neutrality of salary increases (so that salary increases do not lead to a rise in the tax bracket and consequent loss of income), and a greater approximation between the personal income withholding tax and the final tax due (depending on the degree of approximation, this measure may be very relevant in sustaining domestic demand in 2023. Indeed, personal income tax refunds represent 2.2% of private consumption in 2021). It also includes an incentive for the long-term unemployed to enter the labour market (with partial accumulation of unemployment benefits and salary) and an increase in remuneration for overtime (from 100 hours), with a reduction by half of the respective withholding tax rate. Finally, in the case of collective dismissal or termination of employment, the compensation will be increased from 12 to 14 days.

1. Employers' Confederations of Industry, Agriculture, Tourism and Trade and Services, and the UGT.
2. The agreement sets out the following intentions for the minimum wage: 760 in 2023, 810 in 2024, and 855 in 2025. It should be remembered that the minimum wage in 2022 is 705 euros.

Portugal: average monthly base remuneration and objectives reflected in the agreement

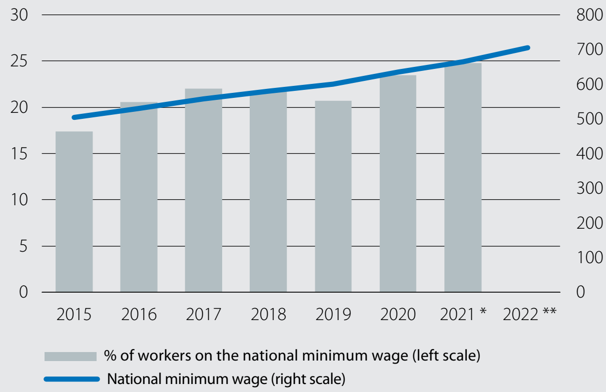
Year-on-year change (%)



Note: ** Gross base monthly average remuneration registered in 1H 2022.*
Source: *BPI Research, based on data from the Wage Deal and the National Statistics Institute of Portugal.*

Portugal: workers on the national minimum wage

(% of total workers) *(Euros)*



Notes: ** Information available for 1H 2021 only. ** No information available for 2022.*
Source: *BPI Research, based on data from the Portuguese Office of Strategy and Planning (GEP).*

On the company side, it is not certain what impact these measures may have, since there will be an increase in personnel costs, but also tax relief measures and an intention to reduce red tape. In this sense, there will be incentives to increase employee salaries through a 50% improvement in the costs of salary increases (including social security contributions) in terms of corporate income tax, responding to objectives such as collective contracting, increasing salaries in line with that established in the agreement and collective negotiation, and reducing salary disparities. Although the share of wages as a part of GDP is far from the Government's target, what is certain is that the share of wages paid in the GVA of companies has increased since 2016: in the first half of 2022, they represented more than 60% of GVA (57% in 2016). Meanwhile, it should be noted that the savings of non-financial companies have also been increasing (more than 20% of GVA), which may provide an important cushion for the increasing costs associated with rises in salaries.

There are also measures that improve company capitalisation through the creation of a Tax Regime of Incentives for the Capitalisation of Companies (ICE), extending the period during which capital increases can be deducted (from 6 to 10 years). There will also be a reduction in company tax for companies that invest in R&D, an increase in the limit of taxable income for SMEs and companies located in the country's interior (from 25,000 to 50,000 euros), as well as for companies that result from mergers (in order to promote the creation of larger companies). Other tax relief/incentive measures include the reduction of sole trader taxation on the purchase of plug-in hybrid vehicles and vehicles powered by natural gas, a freeze on sole trader taxation in the case of tax losses, and incentives to encourage employee training.

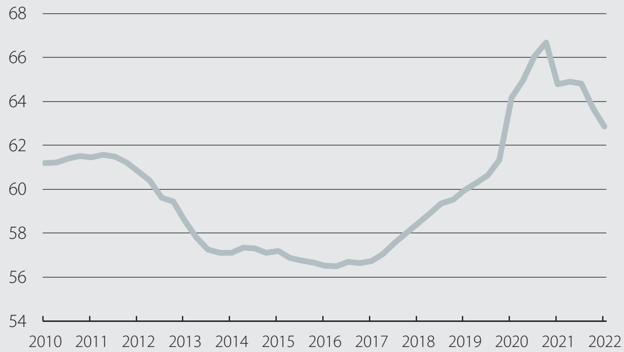
Finally, the agreement also includes measures to minimise red tape and make a more friendly business environment, including a simplification of licensing, changes to the Labour Compensation Fund (including the end of contributions), an end of compulsory quarterly declarations to Social Security for sole traders, new methods of payment to Social Security, and the simplification of licensing for renewable energy production.

This agreement is neither binding nor rigid: it only includes a set of measures that should guide the action of the business and union groups in the coming years and will be evaluated when the State Budget is presented to Parliament each year or if economic and/or social conditions change. Monitoring and follow-up are the responsibility of a working group made up of representatives of the Government and Business and Union Groups, and supported by the Economic and Social Council.

Vânia Duarte

Portugal: wages as a proportion of the GVA of non-financial firms

(%)



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

A year of uncertainty prompts a measured State Budget

We have warned in several articles that 2023 will be challenging on various levels, from the question of energy to the pace of price growth and the impact of rising interest rates, to the strong deceleration of the Portuguese economy. The Government points out that economic growth should decelerate from 6.5% this year to 1.3% next year, a more optimistic scenario than that put forward by BPI Research (see table). Likewise, the goverment anticipates that the unemployment rate will stabilise at 5.6% and that the inflation rate will not exceed 4.0% in 2023 (compared to 5.7% forecast by BPI Research). Even so, and with the possibility of forecasting errors, the public accounts should continue to evolve favourably. Indeed, in the State Budget proposal for 2023, the Government estimates that the deficit will decrease from 1.9% of GDP in 2022 to 0.9% next year.

In the official accounts, the reduction of the deficit is explained by tax and contributory revenue (1.2%) and savings obtained with transitory measures related to COVID-19 and inflation (2.6%), offset by the worsening of interest charges (0.4%.), a significant increase in public investment (0.8%), permanent measures previously implemented and impacting 2023 (1.6%) and new measures (0.4%).[1]

Going into more detail, and analysing the second table, the Government estimates that revenue will increase by 5.9% compared to the estimate for 2022, more than 6.2 billion euros, of which around half is accounted for by tax and contributory revenue and around 35% by capital revenue. In the first case, there is an expected increase in nominal GDP (by 4.9%), which implies an impact not only from the (albeit smaller) growth of the economy, but also from the increase in prices. Tax and contributory revenue should grow by 3.4%, less than expected for nominal GDP, but which is explained by the implementation of new measures (totalling 1.216 billion euros, or 0.5% of GDP),[2] including the updating of personal income tax brackets by 5.1% and the extension of personal income tax to young people. The significant growth in capital revenue is due mostly to the receipt of funds related to the RRP.[3]

For its part, expenditure is expected to increase by 3.7%, or around 4 billion euro, largely due to increased expenditure on personnel, intermediate consumption, interest and investment.Expenditure on personnel is influenced, among other factors, by wage increases to mitigate the rise in inflation, progressions/promotions, career changes, increases in the minimum wage, hirings, and updating the meal subsidy, which together explain

Macroeconomic outlook: comparison between OGE and BPI Research

	2022		2023	
	State Budget 2022	BPI	State Budget 2023	BPI
GDP	**6.5**	**6.3**	**1.3**	**0.5**
Private Consumption	5.4	5.0	0.7	0.5
Public Consumption	1.8	2.0	2.3	–0.2
Investment	2.9	1.7	3.6	3.8
Exports	18.1	16.5	3.7	4.3
Imports	12.0	10.1	4.0	5.0
HICP*	7.4	7.9	4.0	5.7
Employment	1.9	1.6	0.4	–0.3
Unemployment rate (%)	5.6	5.9	5.6	6.4
Current Scale	–1.3	–2.7	–1,1	–2.3

Note: ** CPI in the case of BPI.*
Source: *BPI Research, based on data from the State Budget Proposal 2023.*

Main items in the public accounts

(% GDP)	2019	2020	2021	2022	2023	Variation 2023-2019	Variation 2023-2022
						% GDP	TVH%
Total Revenue	**42.6**	**43.4**	**44.9**	**44.1**	**44.6**	**2**	**5.9**
Tax and contributory revenue	36.6	37.3	37.5	37.7	37.1	0.6	3.4
Capital income	0.4	0.5	1.2	0.7	1.6	1.2	134.2
Total Expenses	**42.5**	**49.2**	**47.8**	**46**	**45.5**	**3**	**3.7**
Personnel expenses	10.8	11.9	11.6	10.9	10.9	0.1	5.5
Intermediate consumption	5.1	5.5	5.8	5.7	6	0.8	10.3
Social benefits	18.1	20	19.4	19	18.1	0	–0.2
Interest	3	2.9	2.4	2.1	2.5	–0.4	23.7
Investment	1.8	2.4	2.6	2.7	3.5	1.6	36.9
Total balance	**0.1**	**–5.8**	**–2.9**	**–1.9**	**–0.9**	**–1**	**–**
Primary Balance	**3.1**	**–2.9**	**–0.5**	**0.3**	**1.6**	**–1.4**	**–**
Public debt	**117**	**135**	**126**	**115**	**111**	**–5.8**	**–**

Source: *BPI Research, based on the State Budget 2023 proposal and INE.*

1. The values presented for savings related to COVID-19 and inflation measures, measures previously implemented and impacting on 2023, and new measures for 2023 are those reported by UTAO («Preliminary Assessment of the State Budget proposal for 2023»), as we consider that they more clearly assess these weights due to the disparity between the value of the Invariant Policies Framework presented in September (negative impact of 3.902 billion euros) and Annex I accompanying the State Budget proposal for 2023 (-5.403 billion euros).
2. UTAO estimates that this amount is lower (854 million euros), considering, for example, the positive effect on withholdings at source and social security contributions resulting from the salary increase for civil servants. See «Preliminary Assessment of the State Budget proposal for 2023», October 2022.
3. According to the information disclosed in the «Informative and Complementary Elements» document, the total PRR grants included in the revenue projections should exceed 3.7 billion euros, with an impact on capital revenue and other current revenue.

the gross increase of 1.430 billion in personnel expenditure (equivalent to 0.6% of GDP).[4]

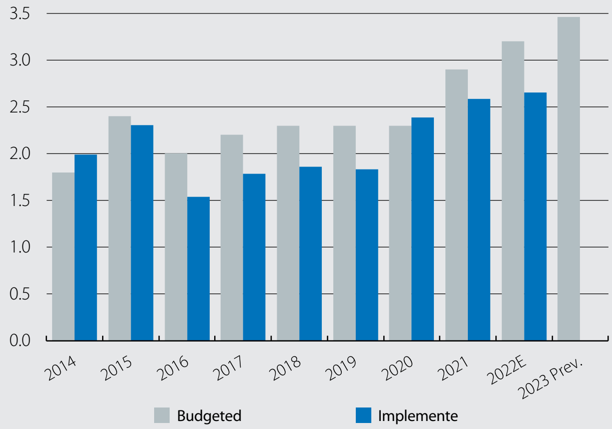
In turn, the 10.3% increase expected for intermediate consumption is explained not only by initiatives foreseen under the RRP, but also reflects the increase in energy prices by Public Administrations and the acquisition of COVID-19 vaccines.Interest charges will increase for the first time since 2014 (23.7%), explained by the tighter financial environment. This increase puts this burden at 2.5% of GDP, the highest value since 2020 (the year affected by the pandemic, and which led the public debt ratio to increase by 18.3% to 134.9%).

Lastly, public investment, which accounts for around 58% of the expected increase in total expenditure in 2023. The Government expects this to reach 3.5% of GDP, a figure only comparable to that recorded in 2011, and to increase by 36.9% in 2023 (more than 2.3 billion euros), a movement supported by structural investments and the RRP. However, considering the history of recent years, this prediction may be too optimistic; indeed, and as can be seen in the graph, public investment has been below budget in recent years, and substantially below 3% of GDP. Additionally, the risks to the implementation of the RRP are likely to be particularly high next year, considering price growth, labour shortages in some sectors of activity (such as construction), and the impact that the environment of greater uncertainty may have on companies' investment intentions.

Meanwhile, social security benefits are expected to decrease slightly compared to 2022, even despite the updating of pensions, the Social Support Index, the increase in the family allowance and other measures which will have an impact of 1.66 billion euros. This is because there were measures implemented in 2022 that will not impact again next year, such as the extraordinary payment of €125 to individuals with gross income below €2,700 per month, or the expected reduction in the burden of sickness benefit by COVID-19.

The State Budget estimates that the public debt ratio will reach pre-pandemic levels (115.0%) in 2022, and should fall to 110.8% of GDP next year, substantially lower than what the Government predicted in the Stability Programme 2022-2026, presented in April of this year (115.4%). It should be noted that high levels of volatility and uncertainty, together with the growing cost of financing, led the Treasury to announce an increase in the liquidity cushion for next year (from 5.9 to 10 billion euros).[5] This is a cautious stance, considering that a considerable part of the increase in revenue comes from

Portugal: Evolution of public investment
(% GDP)



Source: *BPI Research, based on data from INE and the State Budget in each year.*

tax and contributory revenue (which may be adversely affected by the reduction of consumption and/or the increase in unemployment), and that the expected increase in the interest burden represents around 30% of the expected increase in total expenditure.

Finally, it should be noted that, considering our less optimistic outlook for the economy and the labour market (as shown in the first table), which results in more sluggish growth of tax and contributory revenue than that expected in the 2023 State Budget, we anticipate that the deficit next year may be higher than expected (around 1.3%, compared to an estimate of -1.5% in 2022), but still below the 3% of GDP threshold that guides the European budgetary policy rules (although currently suspended). If confirmed, this movement will enable a reduction in the public debt ratio from 115.6% of GDP in 2022 to 113.4% in 2023. Although we estimate that the reduction in the debt ratio may occur more slowly than the official forecasts, this trend still supports the movement towards improving Portugal's rating, in line with what happened recently with DBRS and S&P's, a fact that should be highlighted in a particularly adverse macroeconomic and financial environment.

Vânia Duarte

4. If we consider the positive effect on personal income tax and social security contributions revenues, the net impact is around 867 million euros, according to UTAO.
5. Source: IGCP - Treasury and Public Debt Management Agency.

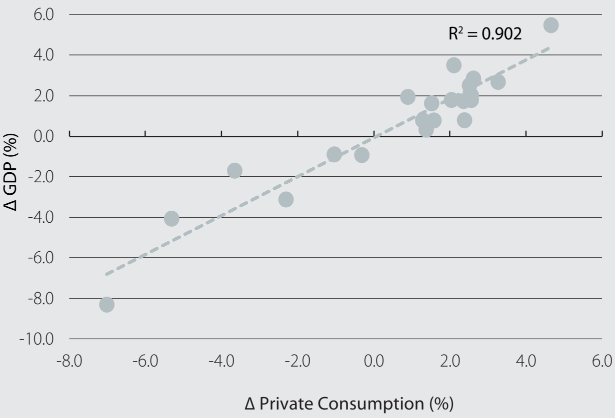
Consumption in 2023: what to expect

Private Consumption is a very important component of Portugal's GDP. In fact, since the beginning of the century, the weight of this component in GDP has been systematically above 60%. Therefore, it is not surprising that there is a strong positive correlation between GDP growth and consumption growth, as the latter is a markedly pro-cyclical variable (first graph). With this in mind, in this article we intend to envisage how this variable may evolve in the next year in a context that is expected to be especially challenging and marked not only by inflation, but also by the tightening of monetary policy.

As we can see in the second graph, after sharp declines «during the troika years», consumption returned to a level of consolidated and fairly stable annual growth (2.5% on average between 2014 and 2019) supported by average annual GDP growth of 2.3% during the same period and cumulative growth in earnings that was higher than cumulative inflation for the same period, meaning there was actual growth in household disposable income.

However, when economic agents make decisions about consumption, especially as regards durable goods, they take their wealth as a whole into account, not just their current income. If we consider all these factors – household disposable income, net financial worth and property assets (which account for a large portion of an individual or family's wealth) – we realise that there are certain periods when consumption levels are above or below that which you would expect based on these *drivers*. For example, between the beginning of 2009 and the end of 2021, we can clearly identify two periods where private consumption was lower than expected (third graph). The first, longer period, was between Q2 2011 and Q2 2014. The second period was between Q1 2020 and Q2 2021. The first period covered the international financial crisis and the time when Portugal received external financial assistance. The second period covered the pandemic. In the first period, we certainly remember that there were the strong reductions in income via cuts in subsidies and extraordinary taxes on income; However, this is not what happened in the second period where average monthly gross earnings rose by more than 3% in both 2020 and 2021. This shows that consumption can grow or decline by more than would be expected by looking at its basic drivers. This can happen for very different reasons and expectations play an important role in influencing the outcome. In the first case, it is likely that economic agents based their consumption decisions on the decline in earnings that they had already experienced

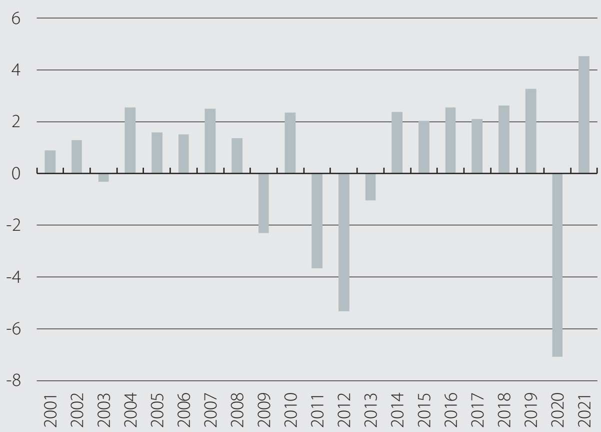
Relationship between GDP and Private Consumption annual growth



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

Portugal: Private Consumption

Annual growth (%)



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

and the possibility that their income would be further restricted in the future through taxes or unemployment: the unemployment rate reached 18.5% in Q1 2013, which coincides with the lowest point on the chart during that period. The second case involves an extraordinary decline in consumption that was largely forced (by the *lockdowns*) and that included a degree of uncertainty regarding the future as the situation was unprecedented and there were major doubts about how long it would last, about the existence and effectiveness of vaccines and about what the economic impact of the phenomenon as a whole would be. Bearing these parameters in mind, what can we expect from consumption in 2023?

To help answer this question, we performed a consumption sensitivity analysis[1] in relation to variations in factors that determine disposable income:

employment, wages and interest rates (we used the 12-month Euribor). Using the value of 5.1%2 and the expected trajectories of the Euribor and the number of employees for 2023 (-0.3% on average compared to 2022) as a proxy for wage trends, we calculated that private consumption would experience a negative growth of –0.6%. The BPI Research forecast is that consumption growth will will be weak in 2023, but still positive at 0.5%.3 We justify this figure based on several areas that were not covered by the sensitivity analysis. Firstly, greater support is expected for those on lower incomes; the minimum wage will increase by 7.8% in 2023 (which is above expected inflation), and the percentage of employees who receive the minimum wage is significant (around 25% according to the latest available data). It should be noted that these lower income households are more likely to spend earnings on consumption expenditure.[4] Secondly, we believe that some of the excess savings accumulated during the pandemic could serve as a basis for maintaining consumption habits. We estimate that in Q2 2022 the value of these savings will still amount to 3% of GDP; and although this aggregate has shown a downward trend in recent quarters, meaning that it is supporting consumption growth, it could continue to do so until mid-2023. In addition, we have also considered the theory that in 2023 there will be a «monetary illusion» effect: Households will lose purchasing power in 2022 and 2023, but the wage increases forecast for 2023 may lead people to believe that price increases are being offset which, in real terms, they are not. Finally, it should be noted that this forecast for growth in 2023 is based on the figures for 2022, which, at the time of writing, are not yet available for Q3.

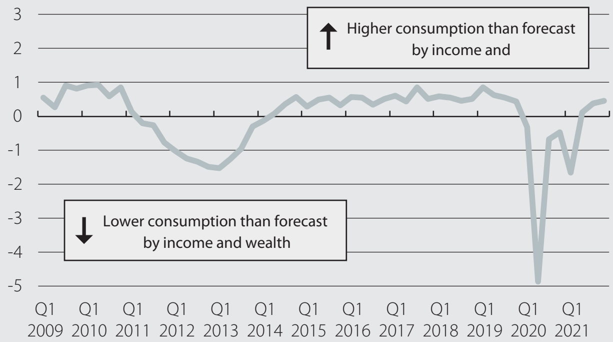
In short, with the erosion of household purchasing power due to inflation and financial burdens, it is expected that private consumption will not be a growth driver in 2023 as in previous years. However, there is room for forecasts to change if the situation becomes more promising because energy prices ease and the geopolitical environment improves.

Tiago Belejo Correia

1. Sensitivities were calculated in two steps. First, the long-term relationship between consumption and its drivers was estimated: gross disposable income, net financial worth of households and house prices (all variables in logarithms and deflated by the CPI). Thereafter, an estimate was made using the return of growth in the consumption chain and growth in the employment chain, wages, the 12-month Euribor and the remainder of the equation used in the first step. The first three factors explain their short-term impact on consumption and the final factor shows the tendency for consumption to return to its long-term trajectory.
2. Target value for wage growth in 2023 included in in the Medium Term Agreement for the Improvement of Income, Wages and Competitiveness signed by the Government and its Social Partners.
3. The Government forecasts growth of 0.7% in private consumption in the General State Budget for 2023 and the Public Finance Council forecasts growth of 0.5%.
4. See the Economic Bulletin for May 2020 from Banco de Portugal, Box 7: "Propensão a consumir em Portugal e na área do euro: uma análise com dados de inquérito" [Propensity to consume in Portugal and in the eurozone: an analysis with survey data].

Relationship between consumption, income and wealth

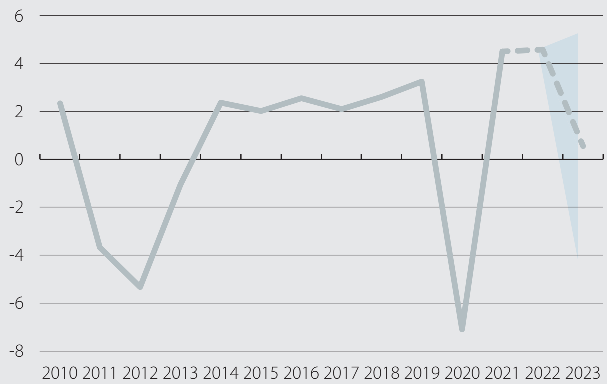
*Standardized index **



Note: ** Remainder from a regression in the private consumption logarithm (in real terms) with the logarithm for gross disposable income, household net financial wealth and housing prices. All variables deflated by CPI. Standardised series with mean of 0 and standard deviation of 1.*
Source: *BPI Research, based on data from the National Institute of Statistics.*

Private consumption: background and forecasts

Annual growth (%)



Note: *The shaded area represents the 90% confidence range for forecast private consumption growth in 2023.*
Source: *BPI Research, based on data from the National Institute of Statistics.*

Recovery and Resilience Plan: situation

The Recovery and Resilience Plan includes estimated investments of Euros 16.4 billion, spread over three areas: resilience, digital transition and green transition, funded by NGEU funds. Of this amount, Euros 13.9 billion is non-refundable and is contingent on the implementation of 341 reforms (milestones) and investments (goals).

Portugal received advance funding of Euros 2.164 billion in August 2021 After the PRR [Recovery and Resilience Plan] was approved by the European Commission, which is equivalent to 13% of the total estimated amount needed to implement the PRR, with the remaining tranches – a maximum of two per year, subject to compliance with the outlined objectives – being deducted from the respective payment. Thereafter, it received a payment of Euros 1.162 billion in May 2022 and asked for a new payment of Euros 1.820 billion in September 2022.

According to the planned schedule, Portugal should have received Euros 7.490 billion in 2021 and 2022, which is equivalent to 45% of the estimated PRR investments. However, to date, it has only received Euros 3.324 billion, which is equivalent to an implementation rate of around 45% during the first two years of the programme. The European Commission is currently analysing the second tranche which, if received in 2022, will increase the PRR implementation rate to around 70% (however, the timings observed for the first tranche suggest that payment will only occur in early 2023). The amounts already received and under analysis are for the completion of 58 milestones and targets, 20 of which were the basis for the request for payment of the second tranche, covering practically all components of the PRR. Of note since the beginning of the programme are the creation and development of the Banco Português de Fomento, reforms in the fields of health, social housing, social services, investment and innovation, qualifications and skills, measures to support digital transition, forestry, blue economy, bioeconomy, renewable gases (including hydrogen), sustainable transport, public finance and public administration.

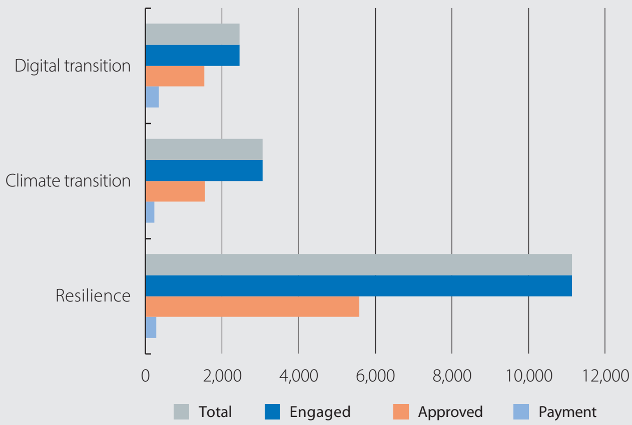
However, there is great disparity between the amounts already agreed, which since April include the total value of investments registered in the PRR in all areas, approvals and payments to beneficiaries. In global terms, 52% of the projects already agreed were approved, but only 5% of the funds were transferred to investors, which could be due to delays in transfers or investments that had already been approved being postponed due greater economic uncertainty.

PRR: Schedule and refunds

	2021 *	2022	2023	2024	2025	2026	Total
Plannedschedule	3,329	4,161	3,329	2,663	2,663	499	16,644
	20%	25%	20%	16%	16%	3%	
% GDP	1.6	1.9	1.6	1.2	1.2	0.2	7.8
Payments made							
Aug-21	2,164						
May-22		1,160					
Sep-22 (request not yet paid)		1,820					

Note: ** Includes 13% advance funding.*
Source: *Version of the PRR dated 22 April.*

Execution of the PRR by size, according to the phase



Source: *BPI Research, based on Recuperar Portugal.*

Approvals and payments to direct and final beneficiaries

(Until October 19)	Approved (million euros)	Payment (million euros)
Families	119	101
Solidarity and social economic inst.	260	3
Companies	2,555	33
Science and technology system inst.	105	5
University education inst.	608	27
Schools	232	211
Municipalities and metropolitan areas	915	41
Public entities	2,580	234
Public companies	1,990	219
Total (million euros)	9,364	874
(% total PRR)	56.3%	5.3%

Source: *BPI Research, based on Recuperar Portugal data.*

From the payments already made, three aspects stand out:

i) the digital transition sphere, including approval of investments in the social, business, school and public administratio[n1] areas, has the highest rate of payments to final beneficiaries (14%);

ii) more than half of the beneficiaries with approved investments and transferred amounts are in the public sector (schools, public entities and public companies);

iii) payment rates are highest for families and schools as final beneficiaries (85% of approved investments have already been paid to families and transfers to schools already exceed 90%). At the opposite end of the spectrum are social solidarity institutions and companies, which have payment rates of below 1.5%, in line with the conclusion that delays in payment could be related to investments being delayed due to rising costs and greater uncertainty about national and international economic performance.

The initial schedule allowed for Euros 3.329 billion to be paid in 2023, if investment decisions are postponed due to higher costs and weaker demand, there could be another year of reduced fund payments and investments planned for the final years of the Plan could be postponed.

Teresa Gil Pinheiro

PRR implementation phases

1st step: Engagement	• Allocation to public entities identified in the PRR (IAPMEI, Institute for Housing and Urban Rehabilitation, Development Bank, Environmental Fund, Central Administration of the IP Health System, Lisbon Metro, IEFP, General Secretariat for education and science, Social Security Institute) and the responsibility for ensuringthat the investments in the plan are defined and implemented. • Engagement with the public entities and institutions that implement (direct beneficiaries) or that choose the bodies that implement (intermediate beneficiaries) investments is performed through the Recuperar Portugal structure.
2nd step: Tenders	
3rd step: Approval of investments	
4th step: Payment	

1. In the payment request for the first tranche, the investment indicators included a tender to create a digital information platform for people with disabilities, the selection of 17 *digital innovation hubs* and the purchase of 600,000 computers for teachers and students; and the request for the second tranche (which has not yet been paid) included investments in public administration digitalisation.

Activity and employment indicators

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

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Coincident economic activity index	–5.3	3.5	6.6	7.4	7.3	6.5	6.5	6.2	...
Industry									
Industrial production index	–6.9	4.5	–1.5	–2.1	2.0	2.1	4.9	0.9	...
Confidence indicator in industry *(value)*	–15.3	–5.3	–1.4	–0.1	–2.3	–4.7	–4.7	–5.4	–6.3
Construction									
Building permits - new housing (number of homes)	0.7	13.5	–6.9	45.5	–23.5	...	–19.0	...	...
House sales	–11.2	20.5	17.2	25.8	4.5	...	–	–	–
House prices *(euro / m² - valuation)*	8.3	8.6	11.0	11.5	14.2	15.8	15.8	15.6	...
Services									
Foreign tourists *(cumulative over 12 months)*	–76.2	51.5	51.5	259.9	298.1	244.4	270.0	244.4	...
Confidence indicator in services *(value)*	–19.0	0.1	12.0	13.0	21.1	17.9	18.9	14.4	11.1
Consumption									
Retail sales	–3.0	4.9	7.3	12.7	3.1	3.2	4.0	2.3	...
Coincident indicator for private consumption	–6.2	4.7	7.4	6.8	5.2	2.9	2.9	2.3	...
Consumer confidence index *(value)*	–22.4	–17.2	–13.5	–19.3	–30.5	–31.8	–31.6	–32.7	–35.2
Labour market									
Employment	–1.9	2.8	3.1	4.7	1.9	...	1.0	...	...
Unemployment rate (*% labour force*)	7.0	6.6	6.3	5.9	5.7	...	6.0	...	...
GDP	**–8.3**	**5.5**	**6.6**	**12.0**	**7.4**	**4.9**	–	–	–

Prices

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

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
General	0.0	1.3	2.4	4.3	8.0	9.1	8.9	9.3	10.2
Core	0.0	0.8	1.5	3.1	5.5	6.5	6.5	6.9	7.1

Foreign sector

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

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	–10.3	18.3	18.3	21.2	18.9	...	21.6	...	...
Imports *(year-on-year change, cumulative over 12 months)*	–14.8	22.0	22.0	33.3	31.5	...	34.3	...	...
Current balance	**–2.1**	**–2.5**	**–2.5**	**–4.3**	**–4.7**	**...**	**–4.5**	**...**	**...**
Goods and services	–3.9	–5.7	–5.7	–6.9	–6.4	...	–5.5	...	...
Primary and secondary income	1.8	3.2	3.2	2.7	1.7	...	0.9	...	...
Net lending (+) / borrowing (–) capacity	**–0.1**	**1.2**	**1.2**	**–0.8**	**–1.3**	**...**	**–2.3**	**...**	**...**

Credit and deposits in non-financial sectors

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

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Deposits [1]									
Household and company deposits	10.0	9.3	9.3	8.9	8.2	7.8	7.9	7.8	...
Sight and savings	18.8	16.3	16.3	15.3	12.9	11.2	11.6	11.2	...
Term and notice	1.2	1.2	1.2	1.1	2.3	3.3	3.1	3.3	...
General government deposits	–21.0	–4.1	–4.1	9.8	8.5	–0.1	5.0	–0.1	...
TOTAL	**8.9**	**9.0**	**9.0**	**8.9**	**8.2**	**7.5**	**7.8**	**7.5**	**...**
Outstanding balance of credit [1]									
Private sector	4.6	2.9	2.9	2.8	2.7	2.0	2.1	2.0	...
Non-financial firms	10.5	2.2	2.2	1.2	1.0	–0.2	–0.3	–0.2	...
Households - housing	2.1	3.3	3.3	3.0	3.8	3.3	3.6	3.3	...
Households - other purposes	–1.1	3.1	3.1	6.4	3.3	3.2	3.2	3.2	...
General government	–4.2	3.8	3.8	5.3	–1.3	–1.9	–0.3	–1.9	...
TOTAL	**4.2**	**2.9**	**2.9**	**2.8**	**2.5**	**1.8**	**2.0**	**1.8**	**...**
NPL ratio *(%)* [2]	**4.9**	**3.7**	**3.7**	**3.6**	**3.4**	**...**	–	–	–

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.*

The Spanish economy applies the brakes, but still shows signs of resilience

GDP growth practically stagnated in Q3. The preliminary GDP figure published for Q3 of this year shows a moderation in the Spanish economy's growth rate, suggesting an increasingly difficult macroeconomic environment, as we anticipated. GDP grew by 0.2% quarter-on-quarter (3.8% year-on-year), a much lower figure than in the previous quarter (1.5% quarter-on-quarter). On the one hand, this figure reflects the fact that the boost provided by the fading impact of the pandemic has been exhausted, while on the other hand it shows the difficult environment that the Spanish economy is currently enduring. This environment is marked, firstly, by high inflation rates; secondly, by a cycle of interest rate hikes that is more aggressive and abrupt than expected a few months ago; and, thirdly, by the deterioration in confidence relating to the economic outlook. Looking ahead to 2023, we forecast that the growth rate of the Spanish economy will slow to 1.0% year-on-year.

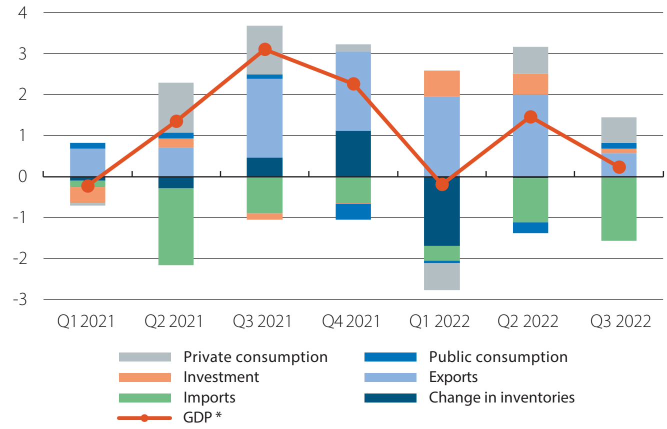
The tourism sector ended the summer season in very good shape. The summer quarter ended with a level of overnight stays in tourist accommodation establishments just 1.3% below that of the summer of 2019, compared to a gap of –27.7% in the summer of 2021. International tourism continued to improve rapidly, reaching a level of overnight stays and tourism spending that was just 5.9% and 3.1% below the same period of 2019, respectively. Domestic tourism reached a volume of overnight stays 6.6% higher than in 2019, although, with more people taking trips abroad, it was 5.2% lower than in the summer of 2021. With a view to 2023, we expect tourism activity to continue to grow and exceed the 2019 level, supported by an improvement in air mobility in Europe, overcoming the episode of airport saturation experienced in the summer, as well as by the recovery of long-haul tourism.

The labour market is holding up better than expected, although it will lose steam in 2023. The October data for social security affiliation show that the labour market remains resilient despite the challenging macroeconomic environment. In particular, the number of registered workers grew by 103,499 people in October, higher than the «usual» figure for October (on average, social security affiliation grew by 82,200 in the month of October between 2014 and 2019). On the other hand, the effects of the labour reform continued to be reflected in the change in the rate of temporary employment. Specifically, it fell to 15.7% (27.6% in October 2021), marking a new all-time low, thanks in part to the use of discontinuous permanent contracts rather than temporary ones. Registered unemployment fell by 27,027 people during October. This is a very encouraging development, given that unemployment usually tends to increase in October (by 69,000 people on average in 2014-2019).

Against this backdrop, we anticipate a slowdown in the labour market in 2023, albeit still with positive job creation (+0.5% compared to 2022). As for the unemployment rate, we expect a slight rise of 3 percentage points versus 2022, bringing it to 13.1%.

Spain: contribution to GDP growth by component

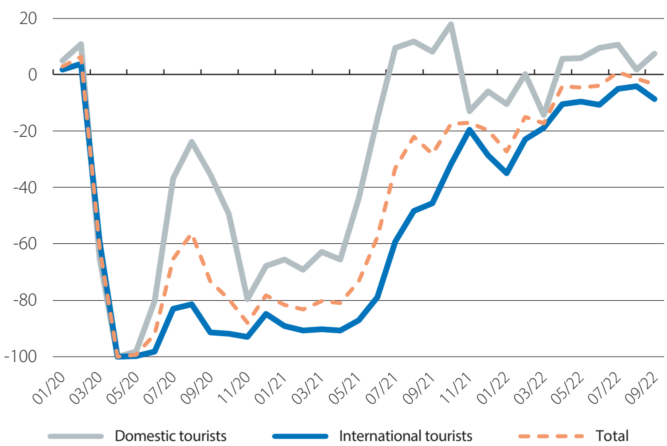
Contribution to the quarter-on-quarter change in GDP (pps)



Note: ** Quarter-on-quarter change (%).*
Source: *BPI Research, based on data from the National Statistics Institute (CNTR).*

Spain: overnight stays in tourist accommodation establishments

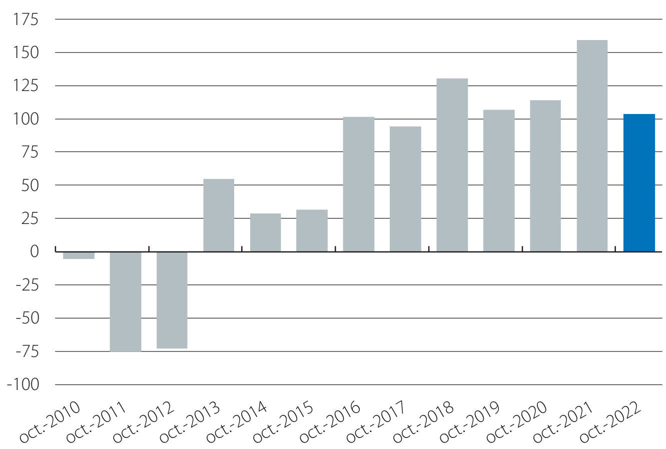
Change versus the same month in 2019 (%)



Note: *Overnight stays of tourists in hotels, rural tourism establishments, tourist apartments and campsites.*
Source: *BPI Research, based on data from the National Statistics Institute.*

Spain: workers registered with Social Security in the month of October

Month-on-month change (thousands of people)



Source: *BPI Research, based on data from the Ministry of Inclusion, Social Security and Migration (MISSM).*

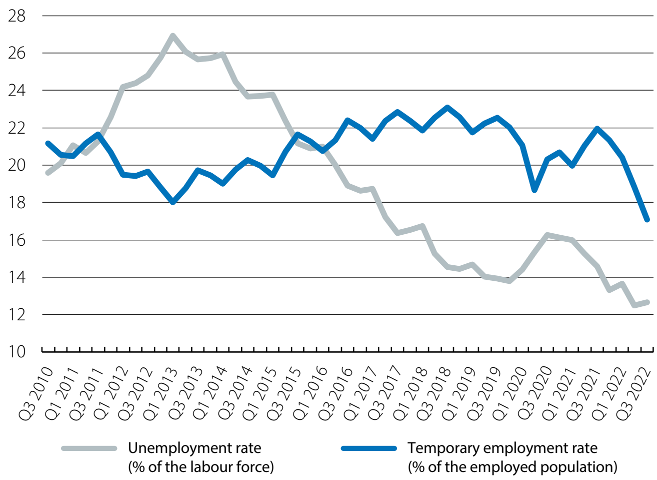
Inflation provides a respite thanks to the energy component, but it will remain high in 2023. According to the CPI flash estimate, headline inflation fell sharply in October and stood at 7.3%, 1.6 pps below the figure for September. Underlying inflation (excluding energy and unprocessed food), meanwhile, remained stable at 6.2% (the same figure as in September). The National Statistics Institute noted that the main reason for the moderation in inflation was the fall in electricity prices, which, according to data from the national grid operator Red Eléctrica de España, reached lows not seen since August 2021. This reduction in electricity prices has been driven by the collapse in the Iberian benchmark gas price (MIBGAS), which fell by 46% in October as a result of the filling of gas reserves and the low consumption due to the high temperatures. As temperatures begin to fall, we foresee a rebound in benchmark gas prices. Looking ahead to 2023, we expect inflation to remain high, at 4.5%, due to the persistence of core inflation.

First signs of lower buoyancy in the housing market, which will experience a slowdown in 2023. Home sales remain high (640,000 in the last 12 months to August), but growth moderated to 15% year-on-year in August, compared to 23% in the first half of the year. In 2023, we expect the housing market to cool, although the absence of imbalances makes a sharp correction unlikely. Specifically, we expect sales to fall by just over 10% in 2023 (to around 480,000 homes), with a slowdown in prices (according to the index by the Ministry of transport, mobility and urban agenda) to an annual growth rate of 1.5%, which in real terms would be a considerable adjustment (–5.6% on a cumulative basis in 2022-2023).

On the other hand, housing supply remains limited: the number of planning permissions granted (108,000 units in the last 12 months to August) falls short of net household creation (180,000 per year to Q2 2022). One factor limiting the recovery of post-pandemic supply has been the sharp rise in construction costs. Recently, the upward trend in costs seems to have slowed (15.1% year-on-year in August, compared to a peak of 19.5% in May). The decline in industrial metal prices on the international markets suggests we will see more contained rises in construction costs going forward.

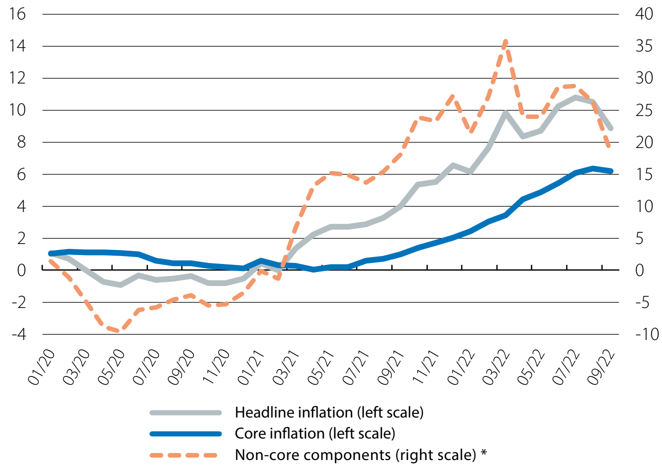
The Spanish government has presented the 2023 Draft General Government Budget and has sent its Budget Plan to Brussels. In terms of the general government deficit, a deficit of 3.9% of GDP is expected in 2023, which represents a 1.1 pp. reduction compared to the deficit projected for 2022. The bulk of this reduction is expected to be driven by the autonomous communities (deficit of 0.7 pps less in 2023), while Social Security would maintain a deficit of 0.5% in 2023. Due to the high uncertainty surrounding the outlook, the Budget Plan delivered to the European Commission included an additional scenario to accompany the 2023 General Government Budget. This second scenario is more in line with the budget execution data for this year and also incorporates more plausible assumptions (e.g. extension of the tax cuts on electricity during 2023). In this second scenario, government revenues are expected to increase by 35 billion euros in 2023 (+6.2% year-on-year), thanks to the strength of tax collections and social security contributions. On the expenditure side, public expenditure is projected to increase by 23.7 billion euros in 2023, 3.8% more than in 2022, due to a significant increase in structural expenditure (mostly on pensions) (see the Focus «The public accounts in 2023: increase in revenues and also in expenditure» in this same report).

Spain: unemployment rate and temporary employment rate
(%)



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

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



Note: ** Aggregate of unprocessed foods and energy products.*
Source: *BPI Research, based on data from the National Statistics Institute.*

Spain: 2023 Government Budget Plan
(% of GDP)

		Scenario 1		Scenario 2	
	2021	2022	2023	2022	2023
Public revenues	43.7	42.1	42.3	42.9	43.0
Indirect taxes (VAT, etc.)	12.2	12.2	12.2	12.6	12.3
Income & wealth taxes	11.9	11.8	12.2	12.2	12.8
Social security contributions	14.2	13.6	13.7	13.6	13.7
Public expenditure	50.6	47.1	46.2	47.9	46.9
Employee remuneration	12.2	11.6	11.4	11.8	11.4
Social benefits	21.8	20.6	20.8	20.7	21.1
Interest charges	2.2	2.2	2.4	2.2	2.4
Subsidies	1.5	1.8	1.2	2.2	1.4
Government balance	–6.9	–5.0	–3.9	–5.0	–3.9

Notes: ** The projections incorporate the macroeconomic impact of the NGEU plan, although the NGEU transfers themselves are excluded from the revenues and the expenditure. Scenario 2 incorporates a higher starting point for forecast tax collections in 2022 (+10.8 billion euros versus scenario 1), in line with budget execution data up to August. It also includes tax measures that are implemented outside the scope of the 2023 General Government Budget, and it assumes that the tax cuts on electricity are extended in 2023.*
Source: *BPI Research, based on data from the Ministry of Finance.*

The public accounts in 2023: increase in revenues and also in expenditure

The Spanish government has presented to parliament the Draft General Government Budget for 2023 and has sent to Brussels its Budget Plan setting out a picture of the consolidated general government accounts. In terms of the general government deficit, a deficit of 3.9% of GDP is expected in 2023, which represents a 1.1-pp reduction compared to the deficit projected for 2022. The bulk of this reduction is expected to be driven by the Autonomous Communities (deficit of 0.7 pps less than in 2023), while Social Security would maintain a deficit of 0.5% in 2023. The latter implies that the government is counting on higher social security contributions and transfers from the state to cover an increase in pensions without altering the deficit (as a percentage of GDP).

With regard to the primary balance, which excludes interest payments, the government projects a reduction of 1.2 pps in 2023 to –1.6%, still greater than the –0.8% of 2019. As for public debt, a reduction of 3.0 pps is expected thanks to GDP growth in nominal terms (6.0%), although it will still remain high at around 112% of GDP.

Revenues: on the rise due to inflation

Due to the high uncertainty surrounding the outlook, the government has presented two scenarios. The first, built on the 2023 General Government Budget, is more conservative in terms of the forecast for 2022 tax revenue collections, projecting that they will be 9 billion euros below the figure we would obtain by extrapolating the budget execution data observed for the year to date up to August. The second scenario, which seems more plausible, incorporates an extra 10.8 billion in tax revenues in 2022 (which in turn leads to around 10 billion in extra revenues in 2023, due to the higher starting point) and assumes that the temporary tax cuts on electricity which are due to expire in December (and which reduced tax revenues by some 6 billion in 2022, according to AIReF) will be extended throughout 2023. Thus, in this second scenario public revenues grow by 6.6% in 2022. This is above the 4.6% in the first scenario, although still far from the 14.0% per the budget execution based on data up to July (which can be expected to moderate in the coming months). This extra increase in revenues in scenario 2 is expected to be used to increase expenditure by a similar amount. Thus, the forecasts for the general government deficit are the same in both scenarios.

If we focus on the second scenario, consolidated general government government revenues are forecast to grow by 6.2% year-on-year in 2023 (+35 billion euros), in line with the government's forecasts for nominal GDP growth (6.0%), which are in the high range of forecasts produced by different analysts. The main factors behind the higher revenues relative to 2022 are projected to include direct taxes (11.2% year-on-year, +16.3 billion euros), favoured by the price rally pushing up tax bases, and social

2023 Budget Plan

Item	2019 (% GDP)	2021 (% GDP)	Scenario 1				Scenario 2			
			2022 (% GDP)	2023 (% GDP)	2023-2019 (% change)	2023-2022 (% change)	2022 (% GDP)	2023 (% GDP)	2023-2019 (% change)	2023-2022 (% change)
Public revenues	**39.2**	**43.7**	**42.1**	**42.3**	**20.4**	**6.5**	**42.9**	**43.0**	**22.3**	**6.2**
Indirect taxes (VAT, etc.)	11.5	12.2	12.2	12.2	18.3	6.0	12.6	12.3	19.3	3.5
Income & wealth taxes	10.4	11.9	11.8	12.2	30.8	9.6	12.2	12.8	37.2	11.2
Capital taxes	0.4	0.5	0.5	0.4	11.5	-15.2	0.5	0.5	39.4	6.0
Social security contributions	12.9	14.2	13.6	13.7	18.4	6.8	13.6	13.7	18.4	6.8
Other revenues	4.0	5	4	3.8	5.9	0.7	4	3.7	3.1	-2.0
Public expenditure	**42.1**	**50.6**	**47.1**	**46.2**	**22.4**	**4.0**	**47.9**	**46.9**	**24.2**	**3.8**
Employee remuneration	10.8	12.2	11.6	11.4	17.7	4.2	11.8	11.4	17.7	2.4
Intermediate consumption	5.1	5.9	5.7	5.6	22.4	4.1	5.7	5.6	22.4	4.1
Social benefits	18.4	21.8	20.6	20.8	26.0	7.0	20.7	21.1	27.9	8.0
Interest expense	2.3	2.2	2.2	2.4	16.3	15.6	2.2	2.4	16.3	15.6
Subsidies	1	1.5	1.8	1.2	33.8	-29.3	2.2	1.4	56.1	-32.6
Capital expenditure (excl. NGEU)	2.8	4.8	3.4	3.2	27.2	-0.4	3.4	3.2	27.2	-0.4
Other expenditure	1.7	2.2	1.8	1.6	4.9	-5.8	1.9	1.8	18.1	0.4
Nominal GDP (EUR billions)	*1,245.5*	*1,206.9*	*1,310.3*	*1,388.7*	*11.5*	*6.0*	*1,310.3*	*1,388.7*	*11.5*	*6.0*

Notes: *The projections incorporate the macroeconomic impact of the NGEU plan, although the NGEU transfers themselves are excluded from the revenues and expenditure. In 2019 we exclude the portion of the deficit (2 percentage points of GDP) relating to Sareb.*
Source: *BPI Research, based on data from the Ministry of Finance.*

security contributions (6.0% year-on-year, +12 billion euros). The latter is expected to be driven by an increase in the maximum base salaries of 8.6% – which is expected to contribute some 0.9 billion – and the 0.6-pp increase in the common contingencies scheme – which is expected to contribute some 2.7 billion euros. Indirect taxes, meanwhile, are expected to register a more contained growth (+3.5%).

The government expects that a part of the higher revenues will come from the new temporary tax measures (the temporary levy on energy and banking and the tax on high-net-worth individuals), which will be partially offset by other targeted measures intended to reduce the tax burden on low and low-middle income households (mainly, the extension of the lower income tax band for employment income from 18,000 to 21,000 euros of gross pay and raising the minimum taxation threshold from 14,000 to 15,000 euros). On aggregate, the government estimates that the new measures will bring in additional net revenues of 4 billion euros in 2023, although AIReF reduces this figure to 3.2 billion; the discrepancy is mainly due to the government anticipating 1.5 billion in revenues derived from the tax on high-net-worth individuals in 2023, while AIReF postpones this income to 2024.

Expenditure: structural increases

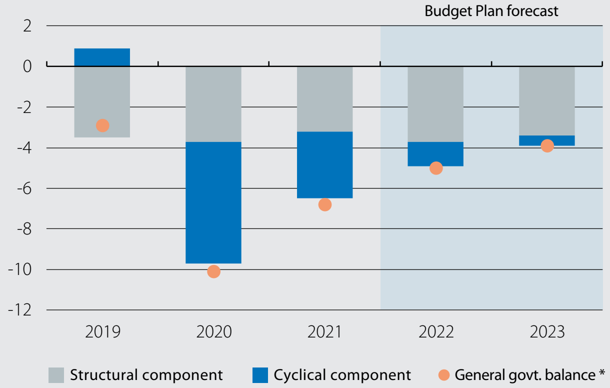
With regard to public expenditure (excluding the items related to the NGEU programme), there is a substantial increase in structural expenditure, especially focused on maintaining pensioners' purchasing power.

In particular, in scenario 2, public spending would increase by 3.8% year-on-year (+23.7 billion euros) in 2023, largely due to a 21.8-billion-euro increase in social benefits (mainly a 19.6-billion increase in pension spending) and the increase in interest charges (+4.5 billion euros). The items expected to fall include subsidies, which are down by 9.4 billion. Therefore, consolidated primary current expenditure would increase by 4.4%, below the government's forecast for nominal GDP growth.

Thus, structural expenditure, which does not directly depend on the business cycle, will increase significantly. Indeed, this is the primarily reason for the 117-billion-euro increase in consolidated public expenditure compared to 2019 (not counting any potential extraordinary spending measures that might materialise in 2023 to tackle inflation and the war in Ukraine): pensions, for instance, are projected to increase by 36.6 billion euros compared to 2019, and staff costs by 24 billion.

Although government revenues will have increased by some 100 billion euros compared to 2019, and much of that increase will be structural – due to inflation[1] and

Spain: government balance
(% of GDP)



Note: ** Excludes Sareb and losses for assistance provided to financial institutions.*
Source: *BPI Research, based on data from the Ministry of Finance (10/2022) and the 2021-2024 Stability Programme.*

structural changes in the economy that have boosted revenues (such as workers previously operating in the submerged economy coming out of the shadows due to labour policies implemented under COVID)[2] – this margin is not expected to be used to reduce the structural deficit by any significant degree. In fact, the structural deficit of the Spanish economy, which was already rather high before the pandemic, will hardly shrink at all. Specifically, according to the estimates included in the Budget Plan, it could stand at around 3.4% of GDP in 2023, very similar to the pre-pandemic level (3.5% in 2019).

1. Even if inflation gradually moderates, the jump in prices versus 2019 is very likely to become consolidated, hence we consider it a structural factor.
2. According to the Budget Plan, the measures adopted during the COVID crisis have led to some 285,000 additional workers registering with the Social Security institute.

Activity and employment indicators

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

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Industry									
Industrial production index	–9.5	8.8	1.7	1.6	4.6	4.7	5.2	3.6	...
Indicator of confidence in industry *(value)*	–13.6	0.6	5.0	6.8	0.4	–5.2	–5.5	–5.2	–3.9
Manufacturing PMI *(value)*	47.5	57.0	56.9	55.8	53.2	49.2	49.9	49.0	44.7
Construction									
Building permits *(cumulative over 12 months)*	–12.8	4.7	24.6	31.6	18.8	...	9.7	...	...
House sales *(cumulative over 12 months)*	–12.5	9.6	32.5	41.8	33.6	...	22.9	...	...
House prices	2.1	3.7	6.4	8.5	8.0	...	–	–	–
Services									
Foreign tourists *(cumulative over 12 months)*	–77.3	64.7	64.7	313.4	311.7	208.4	251.4	208.4	...
Services PMI *(value)*	40.3	55.0	57.4	52.2	55.9	51.0	50.6	48.5	49.7
Consumption									
Retail sales	–7.1	5.1	0.7	0.4	1.1	–0.1	0.1	0.1	...
Car registrations	–29.3	158.0	–17.1	–7.5	–10.3	3.1	9.1	12.7	11.7
Consumer confidence index *(value)*	–22.7	–12.8	–13.1	–17.6	–26.4	–33.1	–31.6	–32.8	–31.8
Labour market									
Employment [1]	–2.9	3.0	4.3	4.6	4.0	2.6	–	–	–
Unemployment rate (% labour force)	15.5	14.8	13.3	13.6	12.5	12.7	–	–	–
Registered as employed with Social Security [2]	–2.0	2.5	3.9	4.5	4.8	3.5	3.5	3.3	3.0
GDP	**–11.3**	**5.5**	**6.6**	**6.7**	**6.8**	**3.8**	–	–	–

Prices

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

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
General	–0.3	3.1	5.8	7.9	9.1	10.1	10.6	8.9	7.3
Core	0.7	0.8	1.7	3.0	4.9	6.2	6.4	6.2	6.2

Foreign sector

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

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	–10.0	21.2	21.2	26.2	22.2	...	23.3	...	...
Imports *(year-on-year change, cumulative over 12 months)*	–14.7	24.8	24.8	36.1	35.2	...	37.3	...	...
Current balance	**6.8**	**11.5**	**11.5**	**8.5**	**9.6**	**...**	**7.8**	...	...
Goods and services	16.3	17.9	17.9	14.2	16.2	...	16.0	...	...
Primary and secondary income	–9.5	–6.4	–6.4	–5.7	–6.7	...	–8.2	...	...
Net lending (+) / borrowing (–) capacity	**11.9**	**22.4**	**22.4**	**19.8**	**22.5**	**...**	**20.8**	**...**	**...**

Credit and deposits in non-financial sectors [3]

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

	2020	2021	Q4 2021	Q1 2022	Q2 2022	Q3 2022	08/22	09/22	10/22
Deposits									
Household and company deposits	7.5	6.1	5.8	5.2	5.4	...	...	...	...
Sight and savings	12.3	10.3	9.2	9.3	9.2	8.2	8.4	7.6	...
Term and notice	–16.5	–24.4	–27.6	–26.8	–25.4	–19.4	–19.9	–16.3	...
General government deposits	1.0	15.5	19.4	19.3	15.6	6.6	11.8	–0.3	...
TOTAL	**7.1**	**6.7**	**6.6**	**6.0**	**6.0**	**...**	**...**	**...**	**...**
Outstanding balance of credit									
Private sector	1.2	0.3	–0.1	0.2	0.8	1.3	1.6	1.1	...
Non-financial firms	4.9	1.1	–1.0	–0.5	0.7	2.4	3.2	2.0	...
Households - housing	–1.8	0.2	1.0	1.3	1.4	1.1	1.1	1.0	...
Households - other purposes	0.8	–1.2	–1.2	–1.1	–0.4	–0.9	–0.9	–0.8	...
General government	3.0	15.3	11.6	3.4	1.9	–3.5	–3.7	–3.8	...
TOTAL	**1.3**	**1.1**	**0.6**	**0.4**	**0.9**	**1.0**	**1.2**	**0.8**	**...**
NPL ratio (%) [4]	**4.5**	**4.3**	**4.3**	**4.3**	**4.1**	**...**	**3.9**	**...**	**...**

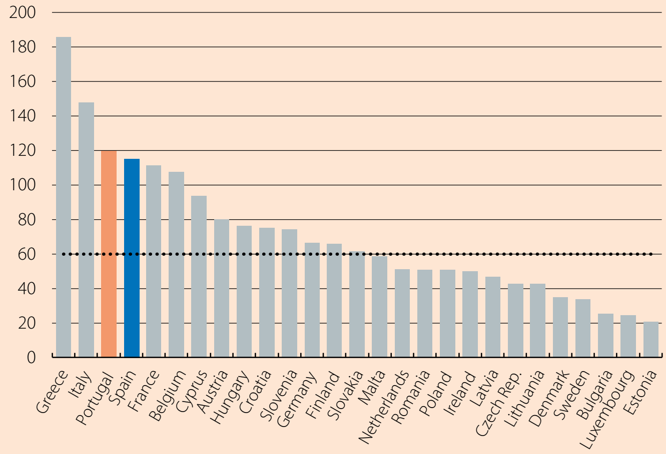
Notes: *1. Estimate based on the Active Population Survey. 2. Average monthly figures. 3. Aggregate figures for the Spanish banking sector and residents in Spain. 4. Period-end figure.*
Source: *BPI Research, based on data from the Ministry of Economy, the Ministry of Public Works, the Ministry of Employment 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.*

Winds of change

The starting point for the international economy in 2023, following the recent barrage of bad news, is all too familiar: heightened geopolitical risk, energy market disruptions, macroeconomic fragility, central banks' drastic response to the inflationary threat, and increased financial instability. This far from rosy picture is the result of the persistent imbalance between supply and demand that has been fuelled by the successive shocks we have faced in recent years (COVID, the war in Ukraine, bottlenecks, etc.). All this has driven the widespread rise in inflationary pressures and the sharp slowdown in growth which has been evident in the economic activity indicators since the summer. The big question is whether this process will culminate in a temporary drop in economic activity (a couple of quarters of negative growth) or whether we will face a deeper crisis that ends up affecting the labour market (stagflation?).

Public debt

(% of GDP)

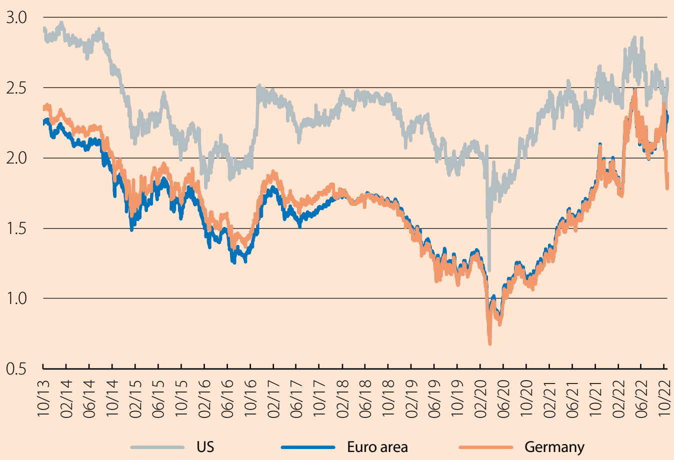


Notes: *European Commission Spring Economic Forecast for 2022. The dotted line corresponds to 60% of GDP, the limit set by the European Treaties.*
Source: *BPI Research, based on data from the AMECO database.*

Economic forecasting is a hazardous task at the best of times, but with the recent volatility in variables that are key to macroeconomic forecasting (energy prices, interest rates and exchange rates), the difficulty of incorporating geopolitical developments and their effects on expectations into the scenarios and, finally, the problem of gauging the monetary and fiscal policy response to the new challenges that are emerging almost daily, the task of making predictions for 2023 is proving particularly complicated. This is especially the case given that market sensitivity has been gradually increasing as global financial conditions have tightened over the past 12 months (+300 bps on average in advanced economies) – a trend spearheaded by the Fed, which after some initial hesitation has charged full steam ahead with no looking back.[1]

5y5y inflation swaps

(%)



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

Indeed, how this shift in monetary policy is digested by the markets, and thus the central banks' capacity (flexibility) to quell any episodes of financial instability, will be one of the key factors in determining the medium-term scenario. After all, the British mini-crisis which culminated in the resignation of Liz Truss has reminded us of the importance of fiscal policy being commensurate with the monetary challenge we face. Times are also changing for the optimal combination of economic policy that the economic situation demands. Ignoring budget tightening with a disorderly fiscal policy would distance us from the monetary authorities' target and increase the risk of financial accidents. In such a situation, the fiscal uncertainty could force the central banks to implement further interest-rate hikes, which would be akin to stepping on both the brake pedal and the accelerator at the same time, as the IMF reminded us at its latest half-yearly meeting.

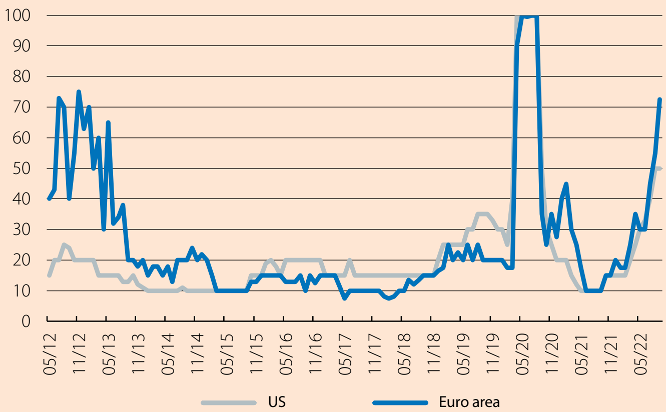
Therefore, at a time when the goals of the fiscal and monetary sides are different, coordination between governments and central banks will emerge over the coming months as one of the key factors in determining how the business cycle will pan out in 2023. It is not easy to go from something resembling fiscal dominance to a regime in which short-term macroeconomic stability is once again a priority, especially with the noise that exchange-rate misalignments can generate. To a large extent, this process

1. For further details, see the article «Is there light at the end of the tunnel? The outlook for monetary policy in 2023», in this same Dossier.

will determine the level at which the current cycle of rate hikes will culminate (the terminal rate), as well as how long it will take for inflation to once again converge on target rates.

In this context, the global economy could grow by 2.7% in 2023, with a sharp slowdown in average growth rates in both advanced countries (1% compared to 2.4% in 2022) and emerging economies (4% compared to 7% in 2022). With the current limited visibility, attempting to extrapolate what form the business cycle will take is a very difficult task. That said, it is logical to anticipate that the crisis will peak over the next six months for Europe, whereas in the case of the US the effects of the Fed's interest rate hikes are likely be felt more acutely in the spring, given the time it takes for monetary policy to affect economic activity. This cooling in demand in advanced economies up until the summer, together with the incipient improvement in the constraints on production, could lead to a gradual normalisation of the imbalances between supply and demand as the year progresses. This would allow for a moderation of inflation and a stabilisation of financial conditions, and it would lay the foundations for a return to potential growth rates beginning in the autumn of 2023, which are likely to be lower than those that existed prior to the pandemic. The question is what the short-term cost will be in terms of economic activity and jobs in order to tackle the inflation problem and, therefore, the fall in GDP over the next two quarters. This «sacrifice rate» will be determined by: the extent to which the energy commodity markets can be stabilised, central banks' credibility, and what happens with regards to second-round effects and thus whether the burden of the cost-of-living crisis we are seeing in so many countries can be shared equitably by increasing wages in line with inflation.

Probability of recession per the Bloomberg consensus
(%)



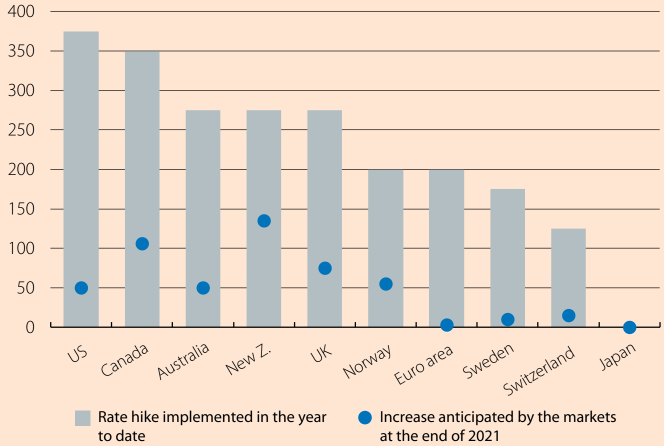
Notes: *Median among analysts participating in the Bloomberg consensus. Probability of recession in the next 12 months.*
Source: *BPI Research, based on data from Bloomberg.*

The global economy will therefore continue to face major challenges in 2023, given the disruptive dynamics that continue to be present. With the unknowns regarding the performance of the Chinese economy and the evolution of the conflict in Ukraine, minimising the damage inflicted on the labour market by the current cycle of monetary tightening, as well as keeping the financial channel isolated from the noise, will be essential. It will be a year of transition, and the conditions must be laid for a return to a certain degree of normality beginning in 2024. However, there may be obstacles along the way, so economic policy must remain flexible and use surgical precision in order to make the most of an ever-shrinking margin for manoeuvre. In short, we will continue to be mired in that phase in which the old has not yet died and the new has not quite been born yet – hence the open debates on matters of such profound importance as: the suitability of current inflation strategies and targets, the role that China will play in the next decade, debt limits in the global economy, and the future of globalisation.

Is there light at the end of the tunnel? The outlook for monetary policy in 2023

2022 will be remembered not only for the intensification and persistence of inflationary pressures but also for the sudden shift in the direction of monetary policy, bringing to an end more than a decade of low rates and ultra-dovish policies.

Official rate hikes announced from January to November 2022
(bps)



Notes: *Data as of 7 November. Market expectations according to the rates implicit in the OIS swaps curve.*
Source: *BPI Research, based on data from Bloomberg.*

Indeed, as of early November, advanced-country central banks have, on average, approved official rate hikes of around 300 bps, marking the most aggressive adjustment since the 1980s and far exceeding what the implicit rates in the financial markets were anticipating at the beginning of the year (see first chart). The central banks have also agreed on an end to their net asset purchase programmes, and in some countries, such as the US, they have even embarked on the process of reducing the size of their balance sheets. As a result, financial conditions have tightened, which has been reflected in historical declines in the main stock indices.

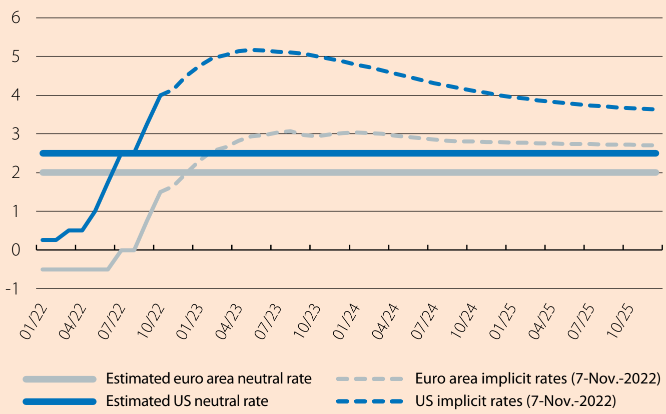
Peak in sight, but at what height?

Following a tumultuous 2022, investors are betting that the current episode of monetary tightening will peak sometime in 2023.

Specifically, as of early November, the rates implicit in the markets were anticipating that official rates would peak this cycle in May in the case of the Fed and in September for the ECB, consistent with additional hikes of 125 bps to 5.0% and 150 bps to 3.0%, respectively. Even for the Bank of England, the official rate is expected to peak during the summer, at around 4.75%.

On the other hand, in the case of the Fed, the implicit rates were anticipating the first rate cuts beginning in September, while for the ECB rates are projected to stabilise in 2023, followed by modest cuts in 2024, in line with CaixaBank Research's baseline forecasts. In both regions, however, it is important to note that the official rates are likely to remain in restrictive territory – i.e. above the level considered neutral (which neither stimulates nor contracts the economy) – at least until the end of 2025 (see second chart). That said, there is a great deal of uncertainty about where these structural levels may actually lie.

Official rates and expectations according to the money markets
(%)



Notes: *Market expectations according to the rates implicit in the OIS swaps curve as of 7 November. The estimated neutral rate corresponds to central bank estimates.*
Source: *BPI Research, based on data from Bloomberg.*

There are a number of factors which justify the expectations that the current cycle of rate hikes will end in 2023. Firstly, the effects of the monetary tightening introduced to date should become more palpable during the course of 2023, given that their impact on the economy is not immediate. Indeed, conventional econometric models estimate that a 100-bp rate hike in the euro area tends to be associated with a maximum impact on GDP after 12-24 months of between 0.7% and 0.9%.[1] Thus, the magnitude of the rate hikes already implemented in 2022 implies that euro area GDP growth in 2023 will be 1.0 to 1.5 pps lower than that expected in the absence of monetary tightening.[2] In any case, we must take these estimates with a large grain of salt, as they are historical averages and may not capture the uniqueness of the current context. For example, the

1. The response of the different variables to a standard monetary shock (+100-bp increase) in our model is very similar to that found in other benchmark models. 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), and the speech by Phillip Lane entitled *The transmission of monetary policy* (11 October 2022).

higher share of new fixed-rate debt (82% in August 2022 for households in the euro area versus 57% in 2010) could mean that the increase in rates will have a smaller impact on the economy. However, the fact that the rate hike cycle has been so pronounced and unexpected, and the starting point so low, could amplify its adverse impact on growth.

Secondly, we do not believe that fiscal policy can, or should, compensate for monetary tightening, in a context of high public debt and higher financing costs. After all, pivoting to an excessively expansionary fiscal policy would likely be punished by the markets with more aggressive rate hikes, raising the risk of a resurgence of fears about the sustainability of public finances, as we saw in the United Kingdom in October.

The interaction of these elements, combined with other headwinds, explains our expectations of a sharp slowdown in the global economy next year, with below-potential growth in most countries. The resulting slowdown in the labour markets, as well as the reduction in inflation expectations, will help limit the risk of second-round effects on inflation and allow for a less reactive stance from the central banks.

As for the supply-side factors that lie behind the current high inflation, with the exception of the maintenance of zero-COVID policies in China endorsed at the recent Communist Party Congress, the disruptions to global supply chains seen throughout the pandemic are likely to continue to moderate. On the other hand, despite the high uncertainty surrounding the future of the war between Ukraine and Russia, the combination of less buoyant demand and the implementation of various containment measures[3] will likely pave the way for a relaxation of commodity prices over the next year, as suggested by the futures markets.

Balance of risks: which way could we go wrong?

It should be noted that there are risks pointing both ways in terms of the direction which monetary policy might take in 2023. On the one hand, we have the risk of inflationary shocks, which could extend the upward pressure on prices and result in more restrictive measures by the central banks. These include a potential escalation of the conflict with Russia, as well as other geopolitical events or natural disasters related to climate change. We also do not rule out further second-round effects, either through higher and more persistent wage increases or due to stronger fiscal stimulus measures.

For illustrative purposes, in a scenario with commodity prices increasing around 50% more than in our central forecast, euro area inflation could remain at the current levels throughout 2023 and not fall back down to 2% until 2026 (we are currently forecasting that this will occur at the end of 2024). In such a scenario, it would not be unreasonable to expect the ECB to raise official rates to around 5%.

On the other hand, there is the risk of disinflationary shocks, such as a de-escalation in geopolitical tensions or a sharper than expected contraction in the economy, whether due to disruptions in the financial markets or any other systemic event. In the event of a geopolitical de-escalation, while we expect the medium-term effect would be less upward pressure on prices, in the short term the positive demand shock – triggered by reduced uncertainty and lower energy prices – would delay the drop in inflation. In this scenario, central banks could respond with additional rate hikes at the beginning of the year (possibly of around 50 additional bps) before initiating a downward cycle thereafter. In the event of a sharp contraction in the economy, however, we would expect central banks to respond by reintroducing monetary stimulus measures, such as net asset purchases in order to stabilise the markets, and possibly even official rate cuts.

2022 has been a year marked by high uncertainty surrounding the economic outlook, both due to the decoupling between supply and demand following the pandemic and due to the war in Ukraine. This has led to substantial forecast revisions, both in relation to inflation and growth and with regard to the response of the central banks. Looking ahead, the forecast for the economy that we can be most sure of right now is that uncertainty will remain high in 2023.

2. In the case of the US, the impact would be greater, considering not only the more aggressive pattern of rate hikes but also the Fed's balance sheet reduction plan. For the ECB, some voices within the Governing Council are already advocating a halt to the reinvestments of assets maturing under the asset purchase programme (APP) in 2023. In any event, the ECB's balance sheet will be reduced in 2023 due to the maturity of several rounds of TLTROs.
3. See the article «Economic policy in the face of the energy challenge: supporting the most vulnerable without distorting the economy» in this same Dossier.

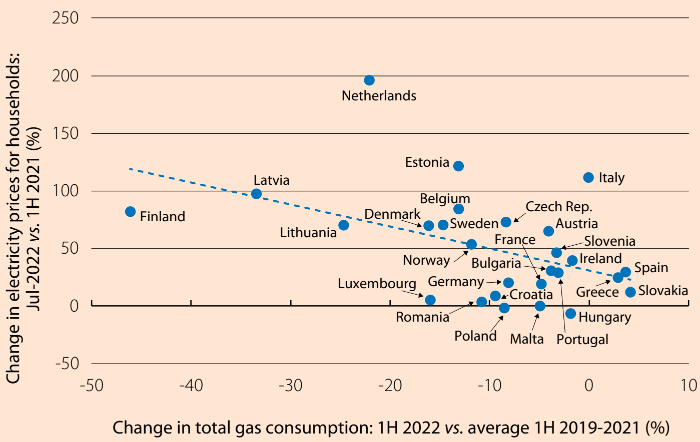
Economic policy in the face of the energy challenge: supporting the most vulnerable without distorting the economy

Economic policy is on a tightrope, as it faces the titanic task of mitigating the impact of the energy shock on households and businesses in a difficult context and with limited fiscal margin for manoeuvre, given that the public accounts have already been dented by the COVID-19 pandemic – indeed, public debt in the euro area surpassed 100% of GDP in 2020, and the deficit exceeded 5.0%. The test in 2022 has been demanding, but with the prospect of energy prices in 2023 still above those before the outbreak of the war in Ukraine, economic policy will once again be at the heart of the debate and will have to roll up its sleeves to propose recipes to cushion this protracted shock.

The line separating success from failure is thin, and success is not guaranteed. The theory is clear, but putting it into practice is not so simple. There are two types of action in the current situation: the first, providing aid through income policies such as direct subsidies; the second, through price interventions (price caps, reducing excise duties on energy and VAT, etc.), and both types of action can be either specific to certain groups or generalised across the wider population. Economists from the major economic institutions (OECD, IMF, etc.) advocate temporary measures that are highly targeted towards vulnerable households to ensure they do not bear the full brunt of the rise in energy prices. Thus, generalised measures – whether price controls or sweeping direct aid – are not recommended, for several reasons:

- They interfere with the inevitable reductions in demand due to the higher prices, which can lead to higher inflation in the medium term, as well as hindering the energy transition.
- They distort price signals, which are necessary to encourage energy saving and incentivise the transition towards a decarbonised economy.
- They can only defer the impact that the price rally will have on households, given that the prospect of a long war means that the current high inflation will persist for longer than initially expected.

Gas: household prices and total consumption



***Note:** The HEPI gathers price data in the capital city of each country, and these are taken as an approximation for the price in the country as a whole as of July 2022.*
***Source:** BPI Research, based on data from Bloomberg and the HEPI.*

From theory to practice: price caps and less targeted forms of aid

Textbook theory is all very well, but governments then have to apply it in a context of social discontent that is essential to tackle. Moreover, it is not always easy to identify who the most vulnerable members of society are. In this regard, advanced economies have faced a veritable energy storm in 2022, and the response of most governments has been closer to that of France (the paradigm of generalist measures and price interventions) than to that of the United Kingdom under Boris Johnson (before its dissolution, his government's actions were close to the IMF's recommendations). As can be seen in the second chart, most of the support in 2022 has focused on economic policies for the entire population that prevent the rise in wholesale energy prices from being passed on to final consumers (price caps, reductions in levies on energy consumption and production, and VAT cuts for energy products, etc.), followed by generalised income policies (either affecting the whole population or very large groups irrespective of their income level, such as users of public transport or those in employment). The measures aimed at supporting vulnerable groups, on the other hand, have been much more limited.

In this context, the proposal put forward by a German think tank contains some interesting elements. They suggest establishing a subsidy on 80% of households' gas consumption (70% for companies), which would result in considerable savings on gas bills.[1]

1. Of 40%, according to some estimates.

At the same time, the scheme maintains the incentives proposed to reduce gas usage: market prices apply on the remaining amount and, moreover, the subsidy would refer to the quantities consumed in 2021. However, they propose applying it to all consumers.

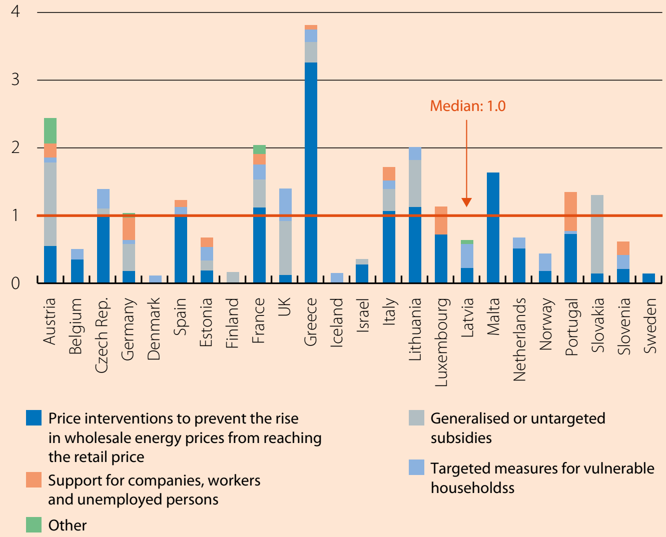
Nevertheless, the scale of the German plan (200 billion euros, slightly over 5% of GDP)[2] has caused a stir due to the risk of distorting the level playing field in the European single market. This brings us to the role that the EU must play, for Europe will better weather the crisis if it is united rather than disbanded.

European coordination

On the one hand, the EU can play a coordinating role in order to avoid negative externalities and exploit positive ones. As an example, with each government focused on securing its own gas supply, the EU could end up with substantial overcapacity in the medium term.[3] In addition, the instinctive national response has generally been to sustain demand with subsidies for gas and electricity consumption, which generates negative externalities and drives up prices across the EU. In the current crisis, however, European solidarity must focus on cutting energy consumption (rather than increasing common spending, as was the case during the pandemic): the key thus lies in coordinating the cuts in usage.[4] Thus, the European Commission's plan is a step in the right direction, insofar as it proposes reducing electricity and gas consumption (by 10% and 15%, respectively).[5] That said, there are some voluntary elements to these cuts and the plan is not free of exemptions.[6]

Europe: fiscal cost of support measures announced in response to higher energy prices

(% of GDP, 2022)



Note: *Measures announced in the first half of 2022 to be deployed throughout the year.*
Source: *International Monetary Fund.*

In the same vein, EU coordination is also important for ensuring the efficient flow of energy between countries. This applies in both the short and long term. In the long run, the decarbonisation of the economy and increased renewable production will lead to more variable power generation, increasing the benefits of a Europe-wide interconnected grid. Improving interconnections in the short term is also essential. The case of liquefied natural gas (LNG), which is key to replacing Russian gas in the current crisis, offers a prime example: 25% of the EU's LNG import capacity is located on the Iberian Peninsula, which in practical terms is disconnected from the large European market. In this regard, the recent agreement between Spain, France and Portugal for the construction of a sea pipeline between Barcelona and Marseille, which in the medium term could temporarily transport gas from the Iberian peninsula to the rest of the continent and in the long term will be used for green hydrogen, is a step in the right direction.

Finally, the EU must ensure a level playing field in the European single market. In particular, given the disparity in Member States' fiscal margin (which the powerful German package has only underscored), a European fund that guarantees a minimal level of support for businesses and households in all countries would make sense.[7] This could involve aid being provided subject to certain conditions being met in order to encourage cooperation between Member States and favour well-designed national policies (for instance, by penalising the implementation of policies that oppose energy saving or which limit international energy flows, and allocating more funds to countries that strive to increase supply, etc.).

2. This 200 billion euros will be distributed between 2023 and 2024, some 90 billion of which is set aside for the partial subsidy for household and company gas bills, while the funds earmarked for the complete nationalisation of the energy company Uniper amount to 30 billion.
3. Of between 30% and 45% of demand by 2030, according to McWilliams *et al.* (2022). «A grand bargain to steer through the European Union's energy crisis». Policy Contribution, Bruegel.
4. Similarly, fiscal and monetary policies must not act in uncoordinated isolation, and the former must not undo the latter's efforts to cool demand.
5. Europe has also approved a cap of €180/MWh on the income of infra-marginal producers (between December 2022 and June 2023) and a tax on the fossil fuel sector.
6. In particular, the 15% cut in gas usage between August 2022 and March 2023 is voluntary, although the European Council may make it mandatory if it activates an emergency clause. In addition, exemptions can be obtained by Member States with key industries that are critically dependent on gas, as well as countries with limited interconnectivity or which export gas at their full potential, among other cases. Moreover, the 10% cut in electricity usage between December 2022 and March 2023 is also voluntary, but it is mandatory to reduce it by 5% at peak times.
7. Taglapietra *et al.* (2022). «Does the European Union need an energy crisis fund?». Bruegel Blog.

Portugal in 2023: a year of clenched teeth?

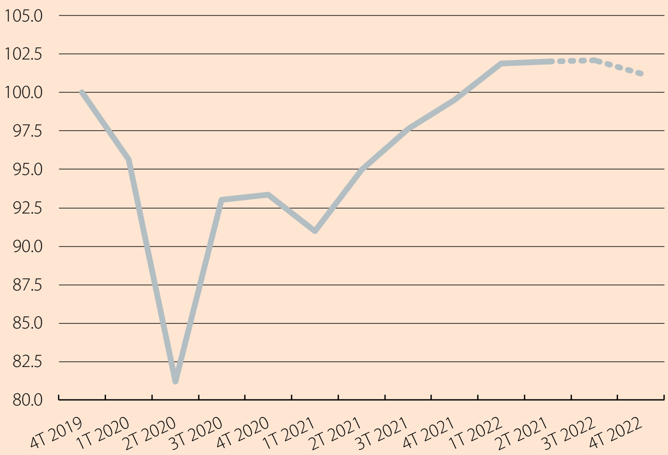
With the end of the year approaching, it is time to take stock and put the country's economic reality into perspective for 2023. If the page of the pandemic seems definitively turned (despite the scars still present in logistics chains), the major certainty we have at the moment is that uncertainty will continue to leave its mark on chapters to come: war, the energy crisis, monetary policy and inflation control. In this text, we seek to shed light on how the Portuguese economy will navigate these turbulent waters.

2022: return to the pre-pandemic and return to inflation

It was a positive year for economic activity, and several factors contributed to this. Firstly, the first months saw strong growth (Q1: +2.4% quarter-on-quarter and +12% year-on-year) motivated by base effects, as Q1 2021 had been one of the most damaging in terms of the effects of the pandemic on the economy. As we can see in the first chart, Q1 2022 marked the breaching of the pre-pandemic plateau at the product level. Furthermore, the growth profile in 2021 implied a carry-over effect corresponding to 3.9 p.p., i.e., this figure would be GDP growth in 2022 if all the quarterly variation rates for the year were zero.

Portugal: Quarterly GDP

Index (Q4 2019 = 100)



Source: BPI Research.

Another lever for growth was the good performance of tourism. As pandemic-related restrictions faded away, the anticipated recovery in tourism services involving personal interactions materialised. Accumulated income at accommodation establishments through August exceeded that of the same period in 2019 by 13%. This performance, with a stronger recovery in non-resident tourism than in 2021, will also be a major boost to external accounts this year: in the 12 months leading up to July, the account balance of tourism services corresponded to 5.6% of the accumulated GDP (current prices), making up for the deficit in the energy account (–4.4% of GDP).

The return of inflation is one of the indelible marks of 2022, with the highest rates in 30 years. At the time of writing, it is almost certain that average inflation in 2022 will exceed the 7% barrier.[1] The phenomenon of rising prices started to become more evident in the second half of 2021 due to the effects of the reopening of the economy and a dynamic demand putting pressure on a supply constrained by the bottlenecks in logistics chains. The outbreak of war in Ukraine provided the backdrop for rising prices as a result of the energy crisis: Brent surpassed 125 dollars/barrel at the beginning of March, while gas prices, faced with the imminence of the indefinite stoppage of gas supply by Russia via Nord Stream, exceeded 300 eur/MWh in August. The transfer of rising prices in energy, an important production factor, to other components of the basket of purchases has been particularly strong in Portugal, with the core component of the consumer price index at very high levels, which suggests the persistence of the inflationary phenomenon.

Meanwhile, the implementation of the RRP has been below expectations, where delays caused by administrative issues, as well as the impact of inflation and the war in Ukraine on the price of materials, affect costs and deadlines of contracts under execution and large works contracts to be formalised. In short, although the external environment may impact the last quarter of 2022 (higher probability of energy rationing or production interruptions in more vulnerable countries in Europe), we expect GDP, in real terms, to increase by 6.3% in 2022.

2023: a year plagued by rising costs

In our scenario, we assume that the economic slowdown at the end of 2022 will extend and deepen in 2023, when the economy will grow by just 0.5%. How can such a sharp slowdown be explained after a strong boost in 2022? Here is our analysis.

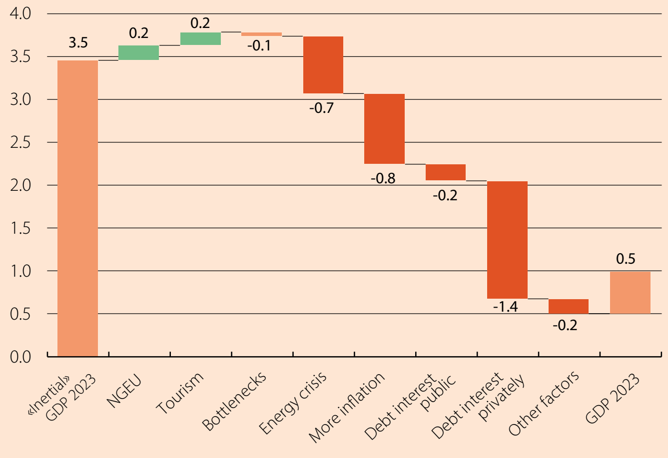
Behind the predicted trajectory are mainly factors exogenous to the Portuguese economy, related to the effects that the energy crisis and the prolongation of bottlenecks in the production chain will have on prices, the response of the ECB to control the inflationary pressures faced by Europe (where Portugal is no exception) and the slowdown of European economies (Portugal's

1. Our forecast is 7.9%.

main trading partners) most dependent on Russian gas supply. As a starting point for our forecast, we estimated what the growth of the economy would be in a normal scenario, i.e. there was no war and inflation and interest rates would not have risen so sharply; this growth, which we estimate at 3.5%, we call inertial growth.

Our scenario assumes that the prices of the main commodities, especially energy commodities,[2] will remain high, prolonging the backdrop of high inflation and foreshadowing a difficult year for families and companies, which will face higher costs associated with the increase in prices and interest rates throughout the year. In this scenario, it is not difficult to foresee a significant slowdown in consumption and a possible deterioration in the labour market. Portugal will also be negatively impacted by the slowdown in external demand and by the more cautious behaviour of economic agents (e.g., in September, consumer confidence was at its lowest since 2013, while the European Commission's economic sentiment indicator is fast approaching stagnation levels).

GDP 2023: contributions to growth
Percentage points



Notes: *«Inertial» GDP 2023 refers to the GDP that would result from not accounting for the associated windfall effects arising from the war in Ukraine and inflation. It was obtained by regressing annual GDP growth with its autoregressive component and the output gap released by the IMF in the October 2022 World Economic Outlook.*

Based on the information we have to quantify the various impacts on the progress of activity in 2023, we estimate that headwinds will be much stronger than tailwinds (see second graph), substantially reducing the pace of growth. Firstly, we wish to highlight the negative impact that the increase in interest rates will have on the growth of the economy, which is explained by the fact that the majority of credit to the private sector is at a variable rate[3] (for households, housing credit — around 80% of the total — continues to be predominantly at a variable rate; for companies, the value of operations contracted at a variable rate since the beginning of 2021 represented around 80% of the total contracted).

Secondly, we will see rising energy costs, reflected in the increase in gas prices and the impact on the cost of electricity production. Although Portugal is not among the European countries most affected by the gas supply interruptions by Russia,[4] it will feel the effect of the price increase, which could take about 0.7 percentage points off growth in 2023.

Thirdly, there is the impact of increased inflation excluding energy on household and business consumption resulting from higher energy costs, which will take 0.8 percentage points off growth next year.

Finally, there are a set of factors that are more difficult to quantify, including the slowdown in external demand, the weakening of the euro and its impact on the cost of imports and the postponement of consumption and investment decisions brought on by greater uncertainty. These factors as a whole could deduct around 0.2 percentage points from growth.

Macroeconomic Scenario

	2022	2023	2024
Δ GDP (%)	6.3	0.5	2.0
Private consumption	4.6	0.5	2.0
Public consumption	1.8	-0.2	-0.2
GFCF	3.0	3.5	6.2
Exports	17.2	4.6	5.0
Imports	11.0	5.5	5.9
Global inflation (%)	7.9	5.7	2.2
Unemployment rate (%)	5.9	6.4	6.1

The tailwinds that will prevent growth from stagnating in 2023 are the European funds and tourism, however, in an environment of high uncertainty such as the current one, their contribution will be small.

As we said at the beginning, uncertainty is the only certainty at the end of 2022 and start the new year. The factors behind this uncertainty suggest that the risks are mostly negative and concern a potential imposition of restrictions on gas consumption and a stronger increase in commodity prices – energy, food and metals – with an impact on prices and conditioned on the degree of tightening of the ECB's monetary policy. In this scenario, we do not exclude the possibility of a contraction in activity. Let's hope not.

Tiago Belejo Correia and Teresa Gil Pinheiro

2. Our scenario anticipates that on average the price of gas will be €196/MWh in 2023, 25% more than in 2022 and clearly above the price of around €20/MWh in the years prior to 2020.
3. Credit market monitoring report: in 2021, 91% of the housing credit stock was at a variable rate.
4. The supply of gas to Portugal by Russia accounts for less than 10%.

All BPI studies and publications are available at: **www.bancobpi.pt**

MONTHLY REPORT

Analysis of the economic outlook for Portugal, Spain and at the international level, as well as the trends in financial markets, with specialized articles on topical subjects.

FLASH NOTES

Periodic analysis of relevant economic issues in the Portuguese economy (activity, prices, public accounts, external accounts, real estate market, banking sector) (only available in English).

COUNTRY OUTLOOK

Economic, financial and political characterization, of the main trading and investment partner countries of Portuguese companies. Brief analysis of the main economic and financial aspects and economic forecasts for the triennium.

Available in English:
Mozambique Country Outlook

Design and production: www.cegeglobal.com

BPI