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MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK
JUNE 2024

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MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK

June 2024

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Resilience, good trends... but there are risks lurking

In this publication we publish the recently adjusted global macroeconomic and financial scenario, which includes an update of our outlook for the Portuguese economy in 2024 and 2025. Of these, the resilience of activity and employment in Portugal in the face of the multiple shocks that have arisen is particularly noteworthy, starting with the Covid crisis and culminating with the explosion in inflation, followed by the largest and fastest increase in interest rates in living memory (at least in the euro region). Added to this resilience are benign developments in internal and external balances - public accounts, external accounts, leverage indicators - which reflect a healthy recomposition of the balance sheets of households, companies and the state. This positive outlook is reflected in the Republic's *rating* upgrades and also in the recent scenario updates by institutions of reference (national and international), although the scenario is not without risks or potential pitfalls, which should also be remembered.

The new macro framework and its changes are detailed in a chapter of this publication, where it is explained that the main changes to the previous scenario stem mostly from the incorporation of the most recent indicators, without jeopardising the trajectory previously outlined. Of particular note is economic growth, which is expected to be sustained and higher than growth in the eurozone; the labour market, robust in a context where increases in the active population and less vigorous job creation coexist, while surveys of the business sector continue to report unmet labour needs; and a slowdown in residential property prices, in a context where activity in the sector is showing signs of picking up and prices are showing positive but more moderate developments.

One of the most important issues when drawing up macro scenarios for Portugal in the medium term is the assessment of trends and risks in the context of government accounts. Indeed, despite positive developments since the pandemic, with a return to significant budget surpluses and a very significant reduction in the debt ratio, this is an ever-present issue, as public debt remains very close to 100% of GDP. This topic is dealt with in a chapter of this publication, which details the assumptions inherent in our projections and highlights some of the risks. In this chapter, the assumptions are extremely relevant and, specifically, our projections are based on the expectation that average nominal growth will be slightly above 4% over the next two years (in 2021-2023 it exceeded 10% on average); interest rates fall in the shorter maturities and stabilise at around 3% in the longer maturities (10 years); and finally, they are based on the premise that fiscal policy will remain cautious, guaranteeing surpluses, albeit decreasing ones. If these assumptions hold true, the public debt ratio will maintain its downward trend and could converge on 90% by the end of 2025.

The main risk factors for the scenario we are presenting are external, related to global geostrategic balances, the evolution of the conflicts raging on Europe's doorstep, the possible delayed effects of the tightening of monetary policy, and potential upheavals in the international financial markets. Domestically, as the Bank of Portugal also emphasises in its most recent Financial Stability Report, one of the main risk factors comes from the challenges facing fiscal policy in the current environment, noting that the public sector remains relatively exposed to a scenario of higher interest rates or volatility in the financial markets. This is not the central scenario and it is true that there are mitigating factors, such as the lower degree of leverage in the economy, but it is a risk that must be monitored and hopefully avoided, given the potential unfavourable impact on other sectors of activity.

Paula Carvalho
Lisbon, 12 June 2024

Chronology

MAY 2024

31 The rating agency Standard & Poor's downgrades France's credit rating from AA to AA–.

MARCH 2024

13 The ECB adjusts the operational framework through which it implements its monetary policy.
19 The Bank of Japan raises its reference rate from –0.1% to 0.1%.

JANUARY 2024

11 NASA confirms that 2023 was the warmest year since records began (1880).
19 Japan becomes the fifth country to land on the Moon.

APRIL 2024

9 The EU's Copernicus programme reports that March 2024 is the 10th consecutive month to set record temperatures in the month since records began (1850).

FEBRUARY 2024

22 The US returns to the Moon after more than 50 years with the landing of Odysseus, the first commercial module to touch down on the lunar surface.

DECEMBER 2023

13 COP28 (United Nations Climate Change Conference) ends with a commitment to transition away from fossil fuels.
20 The European Council approves the reform of EU fiscal rules.

Agenda

JUNE 2024

4 Spain: registration with Social Security and registered unemployment (May).
6 Governing Council of the European Central Bank meeting.
11 Portugal: turnover in industry (April).
11-12 Federal Open Market Committee meeting.
17 Spain: quarterly labour cost survey (Q1).
18 Portugal: resident population (2023).
21 Spain: loans, deposits and NPL ratio (Q1 and April).
Spain: balance of payments and NIIP (Q1).
Portugal: home prices (Q1).
24 Portugal: GDP breakdown (Q1).
25 Spain: quarterly national accounts (Q1).
27 Euro area: economic sentiment index (June).
Portugal: NPL ratio (Q1).
27-28 European Council meeting.
28 Spain: CPI flash estimate (June).
Spain: household savings rate (Q1).
Portugal: CPI flash estimate (June).

JULY 2024

4 Portugal: employment and unemployment (May).
2 Spain: registration with Social Security and registered unemployment (June).
Euro area: CPI flash estimate (June).
10 Spain: financial accounts (Q1).
15 China: GDP (Q2).
18 Governing Council of the European Central Bank meeting.
19 Portugal: DBRS rating.
22 Spain: loans, deposits and NPL ratio (May).
25 Portugal: credit and deposit portfolio (June).
US: GDP (Q2).
26 Spain: labour force survey (Q2).
30 Spain: GDP flash estimate (Q2).
Spain: CPI flash estimate (July).
Portugal: GDP flash estimate (Q2).
Euro area: GDP (Q2).
Euro area: economic sentiment index (July).
30-31 Federal Open Market Committee meeting.
31 Spain: state budget execution (June).
Portugal: CPI flash estimate (July).
Portugal: budget execution (June).
Euro area: CPI flash estimate (July).

Quo vadis Europe?

The European Parliament elections this June were held at a key moment for the European construction process, taking into account the economic, political and social challenges that our continent must address in the coming years. Many of these challenges are discussed in the Dossier of this *Monthly Report* dedicated to the topic. They range from the loss of competitiveness in a world that is undergoing a reconfiguration of value chains and relationships between economic blocs, to the financial challenges involved in strengthening a defence policy in the midst of the energy transition, while not forgetting the challenges linked to the bloc's enlargement and the need to bolster its institutional framework.

If Europe only moves forward in times of crisis, as has become apparent in the last 15 years with the NGEU funds (COVID) and the Single Supervisory Mechanism (financial crisis), then the current opportunity is unequalled, given the scale of the challenges in the international geopolitical context. This Zeintenwende (turning point or change of era), to coin the phrase used recently by Macron and Scholz, should be addressed with ambition in order to lay the pillars of the economic and political union for the coming decades. The alternative is to hesitate, falter, and delay decisions, with a return of the Hamlet-like avatar that has represented the EU many times throughout its history, as Timothy Garton Ash reminded us in his excellent *Homelands: a personal history of Europe*. And the risk of this inaction is the «death of Europe» as we currently know it, as the French President has highlighted in recent weeks, not without a degree of drama.

Therefore, the solution to the challenges, as is almost always the case, is more, not less, Europe. It is essential to maintain the pace of the transfer of sovereignty to European institutions, while remaining aware that progress in the fiscal or political union will face centrifugal forces of all kinds, at a time when the next enlargement will introduce new complications across the entire institutional (and financial) framework. In this context, the list of priority economic issues for advancing the euro area is not all that different from the one that existed prior to the 2019 European elections: completing the banking union with a European deposit guarantee fund, making progress in the union of capital markets and the integration of services markets, strengthening the role of the euro as an international reserve currency or creating a European risk-free asset. It is true that the context has been challenging, and this has delayed progress on structural matters that demanded a high degree of consensus, but it is increasingly important to seal any leaks if we are to make progress with the Economic and Monetary Union. Meanwhile, on the horizon we see an economic policy trilemma, which must be addressed in the medium term and which comprises three spheres: new security and defence policy, open strategic autonomy and the energy transition. This is an enormous financial challenge that will require the multi-annual funding framework to be rebuilt and aligned with the limits of the new Stability Pact, taking into account that the European coffers have been drained by cushioning the supply shocks of recent years, as evidenced by the current public debt ratios in the EU-27 (82.6%) or in the euro area (89.9%). Therefore, many challenges will have to be tackled with limited fiscal margin for manoeuvre and with an ECB that will have to adapt the size of its public debt portfolio to a very different environment than the one which justified the intensive use of unconventional tools.

With the analysis of the challenges that need to be addressed now covered by the publication of the Letta report and, shortly, the Draghi report (innovation, competitiveness, scale, savings deficit, economic and defence security, European public goods, etc.), it is time to get to work. The extent of the ambition of the next term will determine the region's role in a world that is irreversibly doomed to be divided up into blocs, which increases the risk posed by failing to reduce our dependence on the outside for energy or technology (chips, AI, etc.). or allowing growth to remain close to «secular stagnation». Political balances in the region will not facilitate this task and may result in the next advances occurring at different speeds in the face of reluctance from certain jurisdictions to cede more sovereignty; in the meantime, a new enlargement will have to be handled, and this will be no easy task given the countries involved. It may seem that there are too many things on the table, but the only thing that is not permitted at the crossroads at which Europe finds itself is paralysis and complacency.

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

Financial markets

	Average 2000-2007	Average 2008-2020	2021	2022	2023	2024	2025
INTEREST RATES							
Dollar							
Fed funds (upper limit)	3.43	0.77	0.25	4.50	5.50	5.00	4.00
3-month SOFR	3.62	0.99	0.21	4.74	5.37	4.35	3.35
12-month SOFR	3.86	1.42	0.52	5.48	4.95	3.90	3.50
2-year government bonds	3.70	0.99	0.66	4.30	4.46	3.90	3.30
10-year government bonds	4.69	2.44	1.46	3.62	4.01	4.00	3.60
Euro							
ECB depo	2.05	0.15	–0.50	1.77	4.00	3.00	2.25
ECB refi	3.05	0.69	0.00	2.27	4.50	3.15	2.40
€STR	–	–0.55	–0.58	1.57	3.90	2.93	2.25
1-month Euribor	3.18	0.42	–0.60	1.72	3.86	2.93	2.28
3-month Euribor	3.24	0.57	–0.58	2.06	3.94	2.94	2.30
6-month Euribor	3.29	0.70	–0.55	2.56	3.93	2.98	2.38
12-month Euribor	3.40	0.86	–0.50	3.02	3.68	3.03	2.46
Germany							
2-year government bonds	3.41	0.27	–0.69	2.37	2.55	1.90	2.00
10-year government bonds	4.30	1.38	–0.31	2.13	2.11	2.00	2.20
Spain							
3-year government bonds	3.62	1.53	–0.45	2.66	2.77	2.30	2.42
5-year government bonds	3.91	2.01	–0.25	2.73	2.75	2.43	2.57
10-year government bonds	4.42	2.96	0.42	3.18	3.09	2.85	3.00
Risk premium	11	158	73	105	98	85	80
Portugal							
3-year government bonds	3.68	3.05	–0.64	2.45	2.33	2.51	2.66
5-year government bonds	3.96	3.63	–0.35	2.53	2.42	2.57	2.75
10-year government bonds	4.49	4.35	0.34	3.10	2.74	2.75	3.00
Risk premium	19	297	65	97	63	75	80
EXCHANGE RATES							
EUR/USD (dollars per euro)	1.13	1.26	1.13	1.06	1.09	1.06	1.10
EUR/GBP (pounds per euro)	0.66	0.84	0.85	0.87	0.86	0.84	0.86
EUR/GBP (yen per euro)	129.56	126.06	128.82	142.85	156.99	160.00	156.00
OIL PRICE							
Brent ($/barrel)	42.3	77.3	74.8	81.3	77.3	86.0	78.0
Brent (euros/barrel)	36.4	60.6	66.2	76.8	70.9	81.1	70.9

Forecasts

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

International economy

	Average 2000-2007	Average 2008-2020	2021	2022	2023	2024	2025
GDP GROWTH							
Global	4.4	2.9	6.5	3.5	3.2	3.1	3.3
Developed countries	*2.7*	*1.0*	*5.7*	*2.6*	*1.6*	*1.6*	*1.7*
United States	2.7	1.5	5.8	1.9	2.5	2.4	1.8
Euro area	2.2	0.3	5.9	3.5	0.5	0.8	1.7
Germany	1.6	0.8	3.1	1.9	0.0	0.2	1.2
France	2.2	0.3	6.4	2.5	0.9	0.9	1.3
Italy	1.5	–1.0	8.3	4.1	1.0	0.8	1.5
Portugal	1.5	–0.2	5.7	6.8	2.3	1.7	2.3
Spain	3.7	–0.3	6.4	5.8	2.5	2.4	2.3
Japan	1.4	0.1	2.6	0.9	1.9	0.8	1.0
United Kingdom	2.7	0.3	8.7	4.3	0.1	0.5	0.6
Emerging and developing countries	*6.4*	*4.4*	*7.0*	*4.1*	*4.3*	*4.1*	*4.3*
China	10.6	7.5	8.5	3.0	5.2	4.8	4.2
India	7.2	5.7	10.3	6.7	7.7	6.6	6.8
Brazil	3.6	1.2	4.8	3.0	2.9	1.8	1.8
Mexico	2.3	0.7	5.7	4.0	3.2	2.1	2.1
Russia	–	1.0	5.9	–1.3	3.7	1.5	1.3
Türkiye	5.5	4.3	11.4	5.5	4.5	2.6	3.5
Poland	4.2	3.2	6.9	5.9	0.1	2.8	3.6
INFLATION							
Global	4.2	3.7	4.7	8.7	6.8	5.8	4.3
Developed countries	*2.1*	*1.5*	*3.1*	*7.3*	*4.6*	*2.7*	*2.1*
United States	2.8	1.7	4.7	8.0	4.1	3.2	2.2
Euro area	2.2	1.3	2.6	8.4	5.4	2.4	2.1
Germany	1.7	1.4	3.2	8.7	6.0	2.5	2.2
France	1.9	1.3	2.1	5.9	5.7	2.5	2.0
Italy	2.4	1.3	1.9	8.7	5.9	1.5	2.0
Portugal	3.1	1.0	1.3	7.8	4.3	2.5	2.1
Spain	3.2	1.2	3.1	8.4	3.5	3.2	2.5
Japan	–0.3	0.4	–0.2	2.5	3.3	2.0	1.5
United Kingdom	1.6	2.2	2.6	9.1	7.3	2.8	2.3
Emerging and developing countries	*6.7*	*5.5*	*5.9*	*9.8*	*8.3*	*7.9*	*5.9*
China	1.7	2.6	0.9	2.0	0.2	0.5	1.7
India	4.6	7.2	5.1	6.7	5.7	4.8	4.6
Brazil	7.3	5.5	8.3	9.3	4.6	4.3	3.7
Mexico	5.2	4.1	5.7	7.9	5.5	4.5	3.9
Russia	14.2	7.5	6.7	13.8	5.9	5.4	4.5
Türkiye	22.6	9.8	19.6	72.3	53.9	52.6	29.0
Poland	3.5	2.1	5.2	13.2	10.8	4.1	4.6

Forecasts

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

Portuguese economy

	Average 2000-2007	Average 2008-2020	2021	2022	2023	2024	2025
Macroeconomic aggregates							
Household consumption	1.7	–0.1	4.7	5.6	1.7	1.7	2.2
Government consumption	2.3	–0.2	4.5	1.4	1.0	1.2	0.8
Gross fixed capital formation	–0.4	–0.8	8.1	3.0	2.5	3.6	5.1
Capital goods	3.2	2.0	15.3	5.5	4.3	–	–
Construction	–1.5	–2.3	7.4	1.3	–0.3	–	–
Domestic demand (vs. GDP Δ)	1.3	–0.4	6.0	4.7	1.4	2.2	2.5
Exports of goods and services	5.3	2.2	12.3	17.4	4.1	3.4	5.3
Imports of goods and services	3.6	1.5	12.3	11.1	2.2	4.4	5.7
Gross domestic product	**1.5**	**–0.2**	**5.7**	**6.8**	**2.3**	**1.7**	**2.3**
Other variables							
Employment	0.4	–0.6	2.2	2.2	2.0	1.4	1.4
Unemployment rate (% of labour force)	6.1	11.0	6.7	6.2	6.5	6.8	6.5
Consumer price index	3.1	1.0	1.3	7.8	4.3	2.5	2.1
Current account balance (% GDP)	–9.2	–2.7	–0.8	–1.1	1.4	1.2	1.4
External funding capacity/needs (% GDP)	–7.7	–1.5	1.0	–0.2	2.7	2.3	2.6
Fiscal balance (% GDP)	–4.6	–5.1	–2.9	–0.3	1.2	0.3	0.4

Forecasts

Spanish economy

	Average 2000-2007	Average 2008-2020	2021	2022	2023	2024	2025
Macroeconomic aggregates							
Household consumption	3.6	–0.9	7.2	4.8	1.8	2.2	2.4
Government consumption	5.0	1.3	3.4	–0.2	3.8	1.4	1.0
Gross fixed capital formation	5.6	–2.0	2.8	2.4	0.8	2.5	3.6
Capital goods	4.9	–0.8	4.4	1.9	–1.6	2.1	4.6
Construction	5.7	–3.4	0.4	2.6	2.3	3.1	3.1
Domestic demand (vs. GDP Δ)	4.5	–0.9	6.6	2.9	1.7	1.9	2.3
Exports of goods and services	4.7	1.1	13.5	15.2	2.3	2.7	2.4
Imports of goods and services	7.0	–1.0	14.9	7.0	0.3	1.8	2.5
Gross domestic product	**3.7**	**–0.3**	**6.4**	**5.8**	**2.5**	**2.4**	**2.3**
Other variables							
Employment	3.2	–0.9	7.1	3.7	3.2	2.7	2.2
Unemployment rate (% of labour force)	10.5	19.2	14.9	13.0	12.2	11.6	11.1
Consumer price index	3.2	1.2	3.1	8.4	3.5	3.2	2.5
Unit labour costs	3.0	1.2	1.0	0.9	6.0	4.6	3.0
Current account balance (% GDP)	–5.9	–0.2	0.8	0.6	2.6	2.7	2.7
External funding capacity/needs (% GDP)	–5.8	0.2	1.6	1.4	3.6	3.6	3.7
Fiscal balance (% GDP)[1]	0.3	–6.8	–6.7	–4.7	–3.6	–3.0	–2.6

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

Forecasts

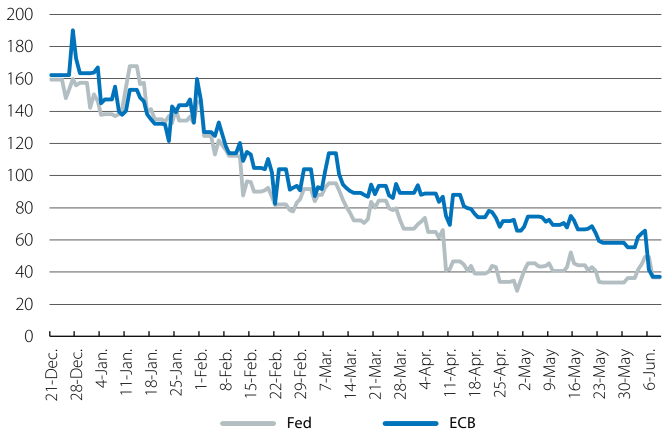
Uncertainty in the interest rate outlook

When will the ECB and the Fed lower interest rates and how many times will they do so in 2024? These are the two key questions on investors' minds and the central theme of the financial markets for much of the year, particularly in the last month. Investors are seeking the answer to these two unknowns amid any macroeconomic data and comments from central bank officials that might shed some light on the path ahead. Thus, in recent weeks, the direction of the markets has been shifting to the tune of what the data has suggested at each given moment. Initially, with indicators showing an easing in the inflation data and a certain cooling of economic activity, sovereign yields fell and stock markets rebounded, but this trend soon turned around amid data that raised doubts over the prospect of a rapid return of inflation to 2%, as well as rather hawkish comments from the central banks. On balance, in May and early June the markets saw volatility in financial asset prices as investors sought clarity on the ECB's and the Fed's future decisions.

Europe leads the rate cut cycle. In May, Sweden's central bank, the Riksbank, announced a 25-bp cut in interest rates to 3.75%. In doing so, it became the second developed-economy central bank to lower rates, following the Bank of Switzerland, which began the cycle of rate cuts in March. They were then joined by the ECB, which announced a 25 bp cut at its June meeting, bringing the depo rate to 3.75% and the refi rate to 4.25%, as had been already widely anticipated by the markets. The question is now the pace of cuts during the rest of the year. President Lagarde was very emphatic in her message that any new decisions would be guided by the data, and stressed that lowering rates in June does not entail a commitment to future cuts. The markets read this emphasis as a hawkish statement and, whereas in early May money markets were anticipating three rate cuts this year, at the close of this publication they were only anticipating one more (bringing the total expected number of cuts in 2024 to two). After all, besides Lagarde's comments, we must take into account the better-than-expected GDP growth in Q1 and the fact that inflation is falling more slowly than anticipated, which is raising doubts in the markets about whether the ECB will implement as many rate cuts as had been anticipated at the beginning of May.

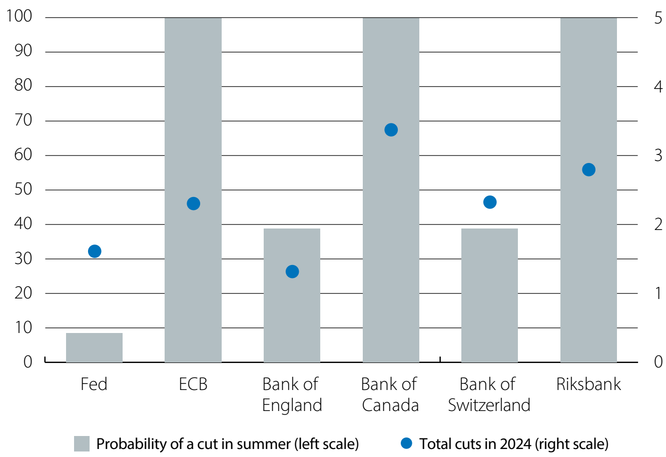
Meanwhile, others will wait until the autumn. Also in Europe, while the Bank of England opted not to lower rates at its May meeting, it showed a more dovish tone and two of its members even voted in favour of a rate cut. However, following an uptick in inflation in April and the announcement of an early general election at the beginning of July, it appears likely that interest rate cuts will begin after the summer. It is also around that time that the Fed is expected to lower rates for the first time by 25 bps, with some uncertainty surrounding the exact month and how many times it will do so this year. In recent weeks, the Fed has appeared concerned about inflation, which remains above 2% and for which the outlook is shrouded in uncertainty.

Expected interest rate cuts by December 2024
(bps)



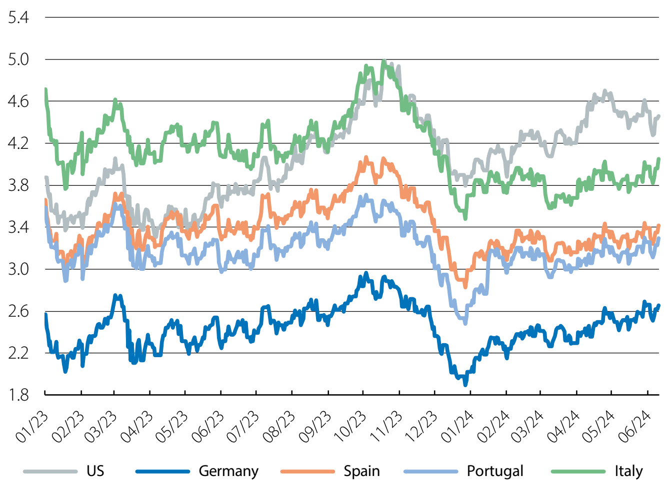
Note: *Forwards on OIS curves as of 10 June 2024.*
Source: *BPI Research, based on data from Bloomberg.*

Monetary policy expectations
(%) *(Number)*



Note: *Forwards on OIS curves as of 10 June 2024.*
Source: *BPI Research, based on data from Bloomberg.*

Interest rates on 10-year sovereign debt
(%)



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

At the close of this report, the markets were clearly anticipating only a single rate cut in the remainder of the year, as the Fed is expected to keep rates high for longer, until it is sufficiently confident that inflation will steadily fall.

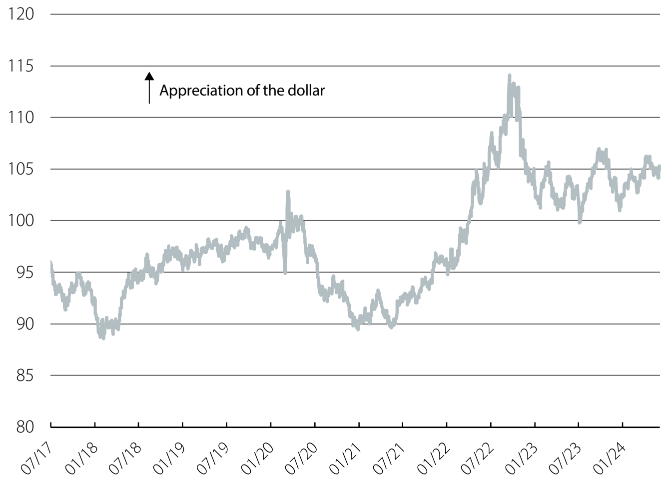
Sovereign interest rates fall but bounce back. The same uncertainty that concerns the Fed is also affecting the financial markets. In the sovereign debt markets, yields began the month by falling after new data indicated signs of cooling in US economic activity (a slight increase in the unemployment rate and a fall in the ISM manufacturing index) and particularly after it was revealed that inflation fell in April. The 10-year benchmarks accumulated falls of up to 35 bps in the US and up to 15 bps in the euro area. However, more hawkish comments from members of the ECB and the Fed, as well as the publication of PMIs which showed a rebound in economic activity, were enough to turn market sentiment around. Since then, yields on sovereign bonds have steadily risen, even pushing the German 10-year benchmark to its six-month high (2.70%). This rally received additional impetus from the ECB's restrictive message at its June meeting regarding its future decisions, as well as from US labour market data for the month of May, which stoked expectations of rates remaining higher for longer. Given this scenario, the dollar, which traded most of the month within a narrow range, appreciated in the latest sessions against its main peers, bringing the euro to 1.07.

The stock markets record ups and downs. The sharp fall in sovereign yields at the beginning of the month, coupled with the conclusion of an earnings season that showed better-than-expected profit growth in Q1, triggered a new rally in the stock markets after having experienced setbacks in the previous month. In fact, the S&P 500, the Nasdaq, and the French and German indices reached new all-time highs. However, as sovereign yields made a U-turn, the stock markets lost momentum and during the second half of May they recorded losses, although these were not significant enough for the main indices to close the month in the red. By sector, US tech stood out, climbing +10% during May, as did the euro area's banking sector, which after having advanced almost 4% last month has now accumulated a gain of around 20% in 2024 to date.

Non-energy commodity prices are pressured upwards. For the first time this year, the Brent barrel price fell (–7.7% monthly in May), placing it at around 81 dollars, mainly due to the weakening of China's economic outlook. All this occurred in the lead-up to the meeting of OPEC and its allies on 2 June, at which members agreed to extend the voluntary production cuts in some countries (2.2 million barrels per day, or bpd) until Q3 2024, with a gradual phase-out planned through to the end of 2025, as well as the extension of the general cuts of 3.66 million bpd through to December 2025. Conversely, metal prices, both precious and industrial, recorded new advances (accumulating growth of over 12% since the beginning of the year). These were driven, on the one hand, by the tensions between supply and demand that exist in many of these assets and, on the other, due to the attractiveness of the financial performance of these assets compared to others such as equities or currencies.

Set of currencies against the dollar

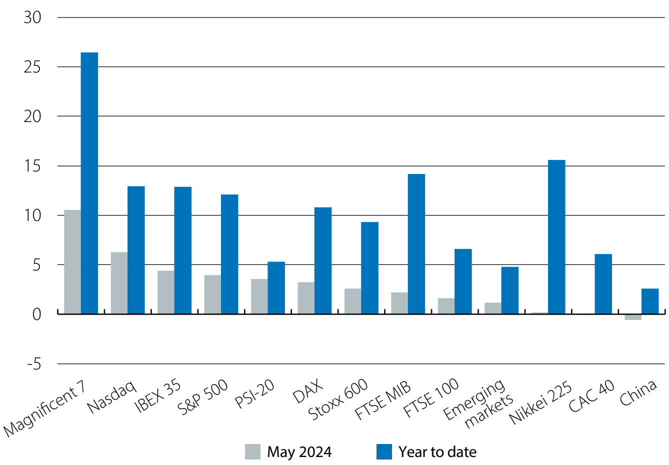
Index



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

Performance of the main stock market indices

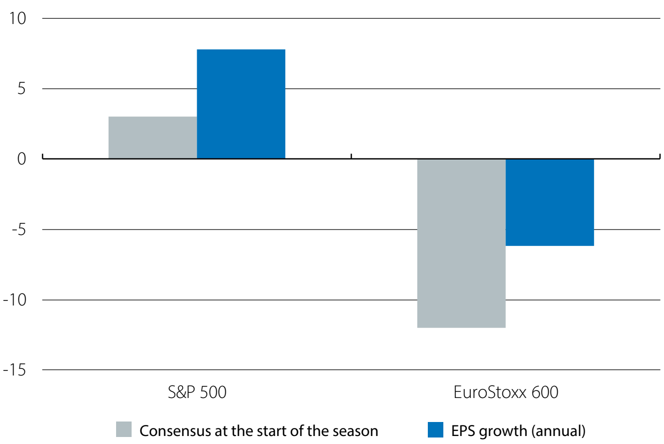
(%)



Source: *BPI Research, based on data from Bloomberg as of 7 June 2024.*

Q1 2024 earnings campaign

(%)



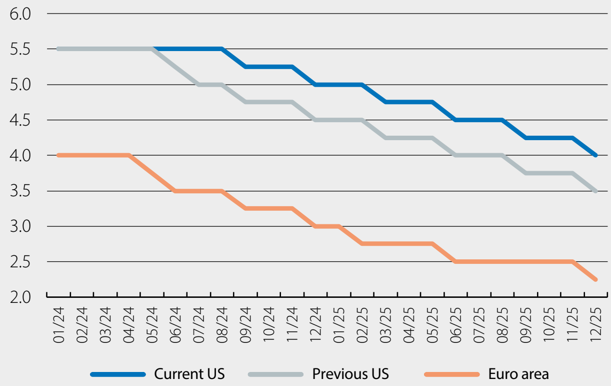
Note: *Estimated EPS growth based on companies that have reported their earnings to date: 98% of the S&P 500 and 81% of the EuroStoxx 600.*
Source: *BPI Research, based on data from Bloomberg.*

The buzzword in the new international scenario: divergence

We are already almost half way through the year and it is time to take stock in order to update the economic scenarios. The indicators that have been published seem to show that the US economy has already begun the long-anticipated soft landing, while the euro area and the United Kingdom surprised analysts with a more dynamic start to the year than expected. At the same time, inflation is proving more persistent than expected in the US, while in Europe its decline is adhering somewhat better to the «script» that we had anticipated. This divergence in the inflation pattern has been key in explaining the adjustments to our interest rate forecasts.

Expectations for benchmark interest rates

(%)



Source: *BPI Research, based on internal forecasts.*

Rising commodity prices, volatile crude oil prices and stabilised gas prices

Despite the fact that inflation is turning out to be more persistent in the US than in other regions, one trend that is common to all cases is that its rate of decline has slowed substantially. In part, this slowdown is natural as the most abrupt forces of the inflationary crisis fade and the composition of the disinflation process changes. However, it also responds to greater demand-side pressure than had been expected a few months ago, as well as to the impact of the rise in commodity prices, some of which are trading at all-time highs (cocoa, copper, coffee, etc.). Moreover, in the specific case of industrial metals, part of their price rise responds to the impact of the new sanctions imposed on Russia, which prohibit Russian metals from trading on international exchanges from 13 April, thus introducing a more persistent upside risk to their prices.

Crude oil prices have shown notable volatility, reflecting the swings in the conflict in the Middle East. As long as this conflict remains active, the risks to the price of crude oil will continue to rise, in a context in which the conditions of its supply are also exerting upward pressures: the productive capacity of the US is reaching its limit, global stocks are at an eight-year low and OPEC has extended its current cuts until October. As a result, we anticipate that the average price of a barrel of Brent oil in 2024 will be around 87 dollars, eight dollars higher than the previous forecast, and 82 dollars on average in 2025, five dollars more than previously projected.

As for the price of gas in Europe, it has remained relatively stable and no significant rebounds are anticipated on the horizon, thanks to gas reserves being at an all-time high. This significant accumulation of stocks has been made possible by an uninterrupted supply of gas in a context of a milder winter than usual, which has kept demand in check. Consequently, we have hardly changed our forecast for the TTF gas price, which we expect to continue to trade at around the 30 euros/MWh mark through to the end of 2025.

The US begins its soft landing with somewhat more persistent inflation

The impressive resistance displayed by the US economy in 2023 seems to be starting to run out, although in reality this reflects a normalisation towards more sustainable growth rates and the indicators seem to suggest some stability in the country's growth in the coming months. The sentiment indicators have tempered (for the manufacturing sector, they even anticipate a stagnation) and the extra savings accumulated during the pandemic have now been practically exhausted. Even the labour market indicators show emerging signs of exhaustion, although it is still very dynamic.

Consequently, all the indicators suggest that the economy has left behind the extraordinary growth rates of last year and that it will converge at rates closer to its potential of 0.4% quarter-on-quarter during the course of 2024 and much of 2025. These forecasts are based on the resilience that household consumption will continue to show, sustained by a labour market that remains buoyant. In addition, a revival of public spending cannot be ruled out, given that we are in an election year. In terms of investment, it will continue to benefit from the stimulus provided by the adoption of new technologies (such as artificial intelligence) and the development of the «green economy» under the Inflation Reduction Act (IRA); a programme with a budget of almost 416 billion dollars between 2023 and 2031. Thus, we revise the expected growth rate for 2024 and 2025 up by 0.2 pps, to 2.4% and 1.8%, respectively.

In this context, inflation in the US is showing greater resistance to the downside than we expected a few months ago, mainly because of the strong inertia of core inflation due to the shelter component, which includes both observed and attributed rental prices. Thus, we revised our headline inflation forecast for 2024 upwards by 0.6 pps, to 3.2%, and raised that of 2025 by 0.2 pps, to 2.2%. For core inflation, we raised the forecast for 2024 and 2025 by 0.5 pps, to 3.2%, and by 0.2 pps, to 2.6%, respectively.

The recovery in the euro area is underway, but it will be rather modest

As for the euro area, and after two quarters of declines, economic activity grew in Q1 2024 by 0.3% quarter-on-quarter, slightly beating expectations. The main indicators suggest that the recovery is underway, albeit a rather modest one, which supports our forecast that growth in the euro area will not exceed 0.4% quarter-on-quarter for the rest of the year. The three major economies will also show relatively stable performance and will grow at rates similar to those recorded in Q1 during the rest of the year. These forecasts are supported by the revival which we expect to see in private consumption, especially in the second half of the year. A labour market that is expected to remain buoyant (the unemployment rate is expected to remain close to its all-time lows), combined with further declines in inflation and the anticipated interest rate cuts, will help to boost consumption. Households will also have a significant savings buffer that will strengthen their balance sheets (it is estimated that, as a result of the pandemic, households have accumulated savings that exceed their usual level of savings by almost 8.0% of GDP). We also expect fixed capital investment to benefit from a wider deployment of NGEU funds: to date, some 224 billion euros (between grants and loans) have been distributed, out of the 672 billion that the Recovery and Resilience Facility has been allocated up until 2026. This scenario barely differs from the one we had previously been defending, so the adjustment to the growth forecast for the euro area is marginal and responds above all to the impact of a somewhat better than expected Q1: we have revised our growth forecast for 2024 by 0.1 pp to 0.8% and we keep the forecast for 2025 unchanged at 1.7%.

Regarding inflation, both the headline and the core measures have shown a marked correction from their peaks, adhering relatively well to the scenario that we have been showing, and we continue to anticipate that headline inflation will converge towards the target over the coming quarters. Therefore, we have revised our inflation forecast for 2024 up by just 0.2 pps, to 2.4%, due to the aforementioned revision of energy prices, and we keep the forecasts for the rest of inflation measures unchanged.

As for the outlook for other economies, of particular note is the upward revision of almost 0.5 pps in the United Kingdom's 2024 growth forecast, placing it at 0.5%, due to an unexpected good Q1 (0.6% quarter-on-quarter, after two quarters of contraction). In China, an also slightly more dynamic Q1 than expected leads us to raise the expected growth rate for 2024 by 0.2 pps to 4.8%. Nevertheless, the questions that continue to hang over the country's residential sector advise caution over the coming quarters, and we cut the growth forecast for 2025 by 0.2 pps to 4.2%.

The ECB will cut rates before the Fed, which has not been the case since July 2012

To close, another of the most significant changes in the scenario has been the adjustment of expectations regarding the Fed's official interest rates. In fact, the resilience of inflation and the buoyancy of economic activity lead us to delay when we expect the Fed's first rate cut to occur until after the summer, and we expect only two rate cuts of 25 bps in 2024, compared to the four initially forecast (–50 bps for the year as a whole vs. –100 bps in the previous scenario). Meanwhile, we keep our scenario of four cuts by the ECB of 25 bps each unchanged, beginning in June, which would bring the official rate down to 3.0% by December (although we do not rule out the possibility of just three cuts in the end). This «de-synchronisation» between the Fed and the ECB will likely be reflected in a stronger dollar in the short term, although in the medium term a convergence in growth rates and monetary policy between the euro area and the US would favour the euro, which we expect to recover an exchange rate of around 1.10 dollars per euro in 2025.

Interest rates (%)

	31-May	30-April	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Euro area					
ECB Refi	4.50	4.50	0	0.0	75.0
3-month Euribor	3.79	3.83	–4	–12.4	29.5
1-year Euribor	3.71	3.70	1	19.8	–16.4
1-year government bonds (Germany)	3.43	3.44	0	17.2	20.8
2-year government bonds (Germany)	3.10	3.03	6	69.3	29.5
10-year government bonds (Germany)	2.66	2.58	8	64.0	35.2
10-year government bonds (Spain)	3.39	3.35	4	39.9	7.7
10-year government bonds (Portugal)	3.26	3.21	5	60.5	26.2
US					
Fed funds (upper limit)	5.50	5.50	0	0.0	25.0
3-month SOFR	5.34	5.33	1	1.1	11.3
1-year government bonds	5.18	5.24	–6	41.3	–5.0
2-year government bonds	4.87	5.04	–16	62.3	37.6
10-year government bonds	4.50	4.68	–18	61.9	80.8

Spreads corporate bonds (bps)

	31-May	30-April	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	53	56	–3	–6.1	–25.4
Itraxx Financials Senior	59	63	–4	–7.9	–28.5
Itraxx Subordinated Financials	106	116	–10	–16.4	–59.6

Exchange rates

	31-May	30-April	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
EUR/USD (dollars per euro)	1.085	1.067	1.7	–1.7	1.3
EUR/JPY (yen per euro)	170.620	168.220	1.4	9.6	13.9
EUR/GBP (pounds per euro)	0.851	0.854	–0.3	–1.8	–1.0
USD/JPY (yen per dollar)	157.310	157.800	–0.3	11.5	12.4

Commodities

	31-May	30-April	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	546.2	546.2	0.0	7.0	0.1
Brent ($/barrel)	81.6	87.9	–7.1	5.9	12.3
Gold ($/ounce)	2,327.3	2,286.3	1.8	12.8	19.5

Equity

	31-May	30-April	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	5,277.5	5,035.7	4.8	10.6	23.2
Eurostoxx 50 (euro area)	4,983.7	4,921.2	1.3	10.2	15.3
Ibex 35 (Spain)	11,322.0	10,854.4	4.3	12.1	21.5
PSI 20 (Portugal)	6,870.8	6,615.6	3.9	7.4	16.4
Nikkei 225 (Japan)	38,487.9	38,405.7	0.2	15.0	22.1
MSCI Emerging	1,049.0	1,046.0	0.3	2.5	6.6

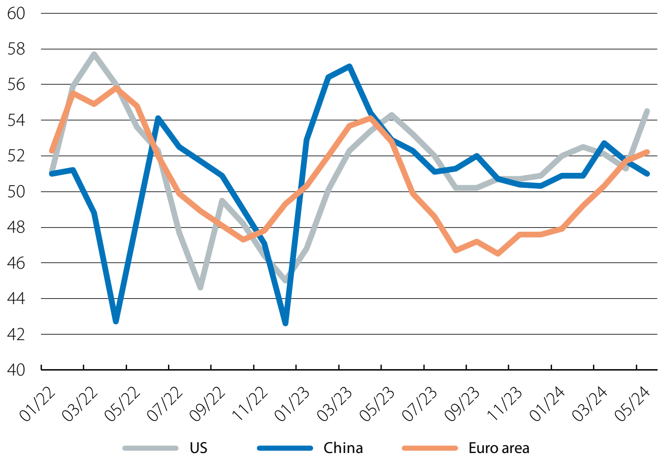
The international economy, in search of an orderly landing

Global economic resilience, but with regional disparity. As the general elections in India and Mexico were being brought to a close at the beginning of June, the electoral year continued its course with the European Parliament elections held from 6 to 9 June. These latter elections mark the beginning of the 2024-2029 term, which will involve significant challenges, as we analyse in this month's Dossier. With the latest data to hand, the global economy is navigating this electoral calendar with resilience: the global composite PMI accelerated steadily to 53.7 points in May, and it is expected that for 2024 as a whole global GDP will grow by just over 3% (a similar figure to 2023 but below the average of the last 20-30 years), supporting a recovery in international trade. This resilience at the aggregate level, which is quite remarkable given the significant geopolitical uncertainty and restrictive financial conditions dominating the scenario, reflects disparate dynamics among the various international economies, with each one seeking to make an orderly landing amidst their own challenges: the US is experiencing strong growth and is seeking to normalise towards more sustainable rates, while the euro area is showing signs of less apathetic growth and China maintains mixed dynamics between industry and domestic demand.

Solid economic activity in the US. On the one hand, US indicators continue to show solid economic growth, with its composite PMI standing at 54.5 points in May (54.4 in April) and trackers that point to GDP growing at rates of slightly above 0.4% quarter-on-quarter in Q2. On the other hand, there are various signs suggesting a slight moderation in growth towards more sustainable rates after a much more robust 2023 than expected. Thus, in May the quarter-on-quarter GDP growth rate for Q1 was revised downwards to 0.3% (–0.1 pp), mainly due to a slightly less dynamic private consumption than anticipated (a trend also reflected in the latest data on personal consumption, decelerating from 0.7% month-on-month in March to 0.2% in April). Also, in May the Fed's Beige Book reported that, so far in Q2, «slight or modest» growth has been observed in most districts of the United States. Finally, these disparate signs are also reflected in the labour market, with an unemployment rate that rose to 4.0% in May (+0.3 pps year-on-year), but at the same time with dynamic job creation (+272,000).

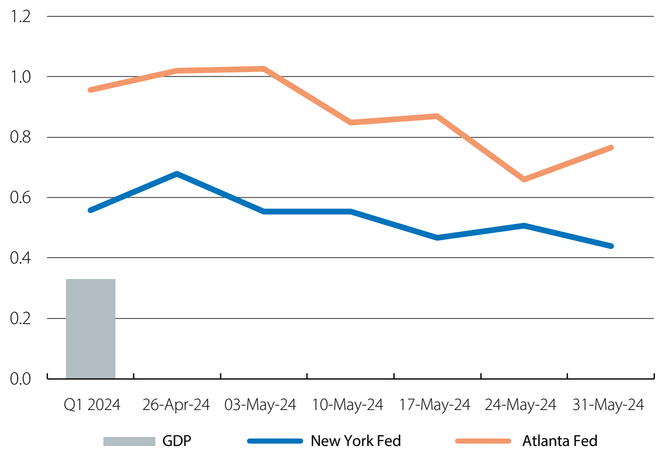
American inflation offered a respite in April. After two months on the rise, in April headline inflation fell by 0.1 pp to a year-on-year growth in the CPI of 3.4%. The 0.2-pp moderation of core inflation (3.6%) was a particularly positive development, as this indicator had been showing significant persistence since the end of 2023. However, items such as shelter (services related to housing) remain at very high levels (5.5%) and, given their weight in the CPI basket (accounting for over 35% of the index), they are preventing headline inflation from making further downward progress. Shelter accounts for a smaller portion of the PCE price index, which is why this inflation measure, which is preferred by the Fed, is lower.

International economic activity: composite PMI
Level



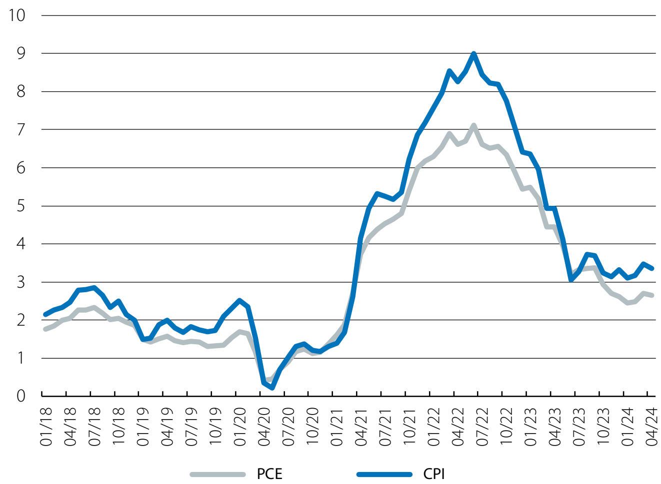
Source: *BPI Research, based on data from the S&P Global PMI and the National Statistics Office of China.*

US: economic activity indicators for GDP in Q2 2024
Quarter-on-quarter change (%)



Source: *BPI Research, based on data from the BEA, the New York Fed and the Atlanta Fed.*

US: headline inflation
Year-on-year change in the price index (%)



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

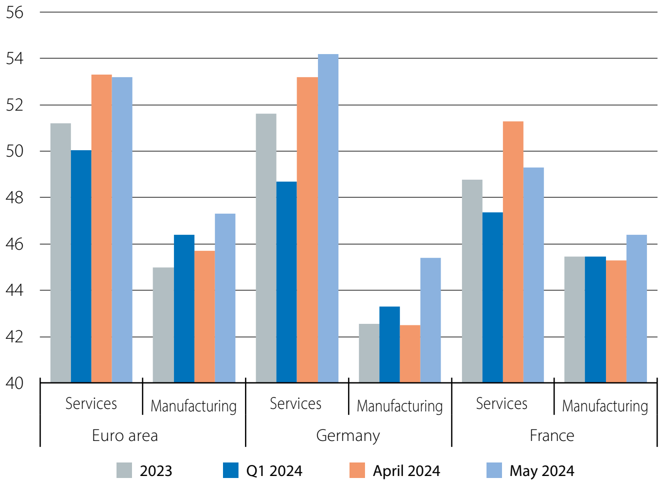
That said, it has also recently exhibited more inertia than expected (rising from 2.5% year-on-year in January to 2.7% in April), which supports the expectation of a more cautious Fed when it comes to implementing rate cuts.

Signs of revival in the euro area. In Q1, with GDP growth of 0.3% quarter-on-quarter, the euro area managed to leave behind the ±0.1% range in which it had been stranded since Q4 2022, and it did so with a positive performance in all major economies. This dynamic is continuing in Q2, with the region's composite PMI accelerating to 52.2 points in May (12-month high) and reflecting both an improvement in services (53.2) and signs of stabilisation in industry (47.3 points in May, which marks the best figure in the last 14 months, although it is still in slightly recessionary territory). This improvement is primarily led by the countries of the periphery, although the data also point to a certain revival in Germany, one of the economies with the most sluggish growth so far. The recovery of sentiment in the euro area as a whole is also taking place in a context of continued strength in the labour market, with an unemployment rate that fell to a low of 6.4% last April. All this gives greater confidence in the expected reinvigoration of economic activity, although we do not expect a very significant acceleration; rather, GDP is expected to maintain the growth rate of around 0.3% recorded in Q1 over the following quarters.

European disinflation shifted down a gear in May, with the headline HICP up 2.6% year-on-year in the euro area as a whole and an acceleration in core inflation (excluding food and energy) to 2.9% (+0.2 pps with respect to April in both cases). Although the euro area has recorded a very sharp decline in price pressures from its peak of 10.6% (in October 2022), the disinflationary process has slowed down in recent months (e.g. in December 2023 it already stood at 2.9%). This is a result of disparate dynamics between components: whereas the source of energy disinflation is now practically exhausted (+0.3% in May, marking the first positive year-on-year rate of change in a year), services are more inertial and still have a long way to go (4.1% in May). In addition to all this, base effects related to support measures introduced to tackle the energy crisis are persisting, and although they will not compromise inflation's return to 2%, they will lead to volatility in the coming months.

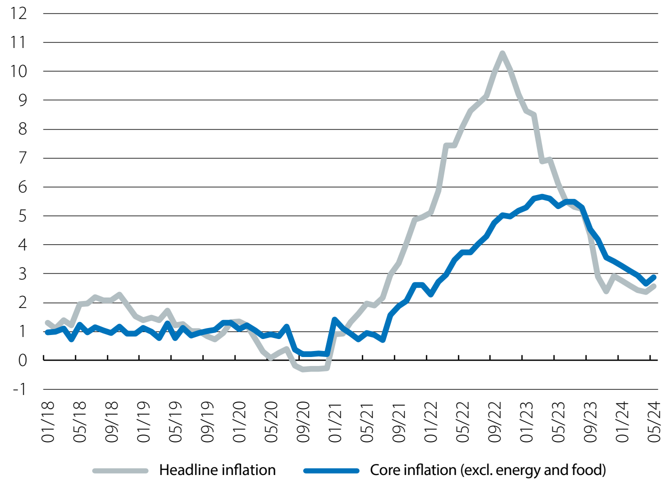
China, at two speeds. The data for Q2 continue to paint a picture of a duality in the Chinese economy, with the momentum of industry on one side and the weakness of domestic demand on the other. In April, industrial production accelerated to 6.7% year-on-year (4.5% in March), while retail sales slowed to 2.3% (3.1% in March). Adding to these mixed dynamics, in May the PMIs showed signs of a slowdown, with a decline in the manufacturing sector to 49.5 points (50.4 in April), stagnation in the services sector (50.5 points in May vs. 50.3 in April) and a drop of almost 2 points in the construction PMI, to 54.4. Overall, the composite PMI stood at 51.0 points (vs. 51.7 previously), reflecting an economy that grew with less intensity in Q2. Looking ahead over the coming months, China's ability to revive domestic demand will remain one of the key questions while a relaxation of fiscal policy is awaited in the short term. India's GDP, meanwhile, beat expectations once again, recording a year-on-year increase of 7.8% in Q1.

Euro area: PMI
Level



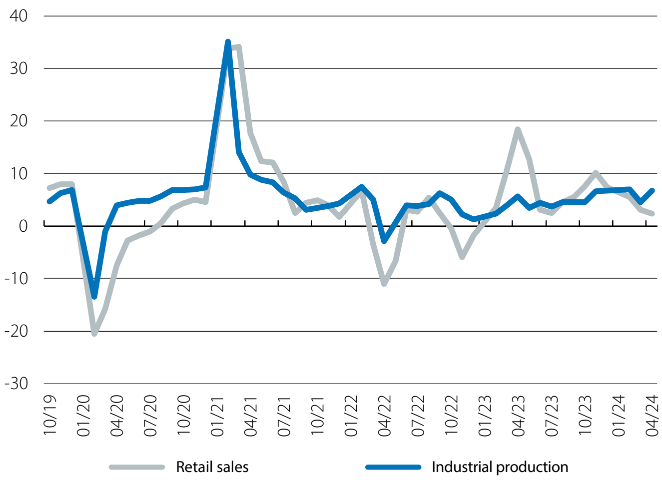
Source: *BPI Research, based on data from S&P Global PMI.*

Euro area: HICP
Year-on-year change (%)



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

China: economic activity indicators
Year-on-year change (%)



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

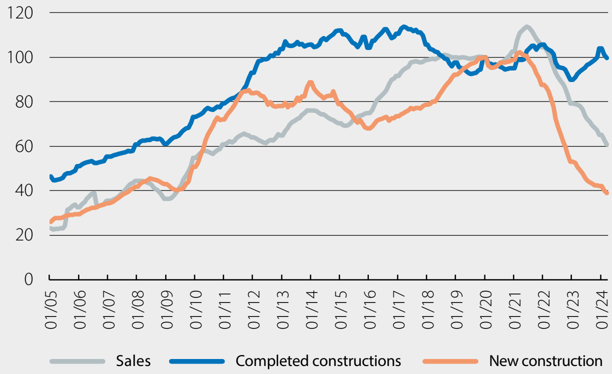
China's real estate sector: an updated diagnosis

After years of rapid expansion, the Chinese authorities have decided to put a stop to excessive leveraging in the real estate sector. On the one hand, they were concerned about the financial risks stemming from an uncontrolled housing bubble and, on the other hand, they had in mind the new guidelines of the «Common Prosperity» agenda, which in the real estate sector translated into the mantra «houses are for living in, not for speculation». In this context, beginning in the summer of 2020 new limits on access to credit for property developers were imposed and the sector entered a prolonged phase of adjustment in which it still remains today.

A quick take of the pulse suggests that this adjustment is proving to be rather dizzying, especially since 2021, when the crisis affecting the real estate giant Evergrande broke out, triggering intense scrutiny of the sector among investors while leading to a crisis of confidence among buyers and fears of contagion to the financial sector. Sales have plummeted by almost 50% since their peak and new construction has fallen by 60%, reaching levels similar to the post-financial crisis era (see first chart).

China: real estate sector indicators

Index (100 = December 2019)



Note: *The indices are calculated based on the 12-month averages.*
Source: *BPI Research, based on data from the National Statistics Office of China, via Bloomberg.*

Vital signs stabilised, but with persistent symptoms

In this environment, the central role of real estate as a savings vehicle has led to a significant negative «wealth effect» among Chinese households. Moreover, while real estate was one of the main engines of the Chinese

China: map of indicators of the real estate and construction sectors

Activity indicators	2010-2019	2021	2023	*Latest figure*	2023 vs. 2021 (%)	vs. 2010-2019 (%)
Sales (mill. m²) *	125.0	163.1	101.6	95.0	–37.7	–18.8
New construction (mill. m²) *	168.0	180.8	86.7	80.5	–52.0	–48.4
Completed constructions (mill. m²) *	88.2	92.2	90.8	87.0	–1.6	2.8
New construction (mill. m²) *						
Property developer survey **	6,871.2	9,753.9	8,383.6	–	–14.0	22.0
Construction sector survey **	11,593.6	15,754.6	15,134.3	–	–3.9	30.5
Land sales (mill. m²) *	83.7	99.5	80.0	77.1	–19.6	–4.4
Tier 1 and 2 cities	64.3	71.4	54.4	52	–23.8	–15.4
Tier 3 cities	19.4	28.1	25.6	25.1	–8.7	32.2
Total investment (construction) (CNY billions)	9,009.8	14,224.8	11,091.3	–	–22.0	23.1

Real GDP and price growth (%, YoY change)	2010-2019	2021	2023	*Latest figure*	2023 vs. 2021 (%)	vs. 2010-2019 (%)
GDP (aggregate)	7.7	8.4	5.2	5.3	–3.2	–2.5
Sectoral GDP						
Construction	8.3	4.1	7.1	5.8	3.0	–1.2
Real estate	5.4	4.3	–1.3	–5.4	–5.7	–6.7
Home prices (new builds)						
Tier 1 and 2 cities	5.5	4.3	0.1	–2.0	–4.2	–5.4
Tier 3 cities	3.5	4.2	–1.7	–3.3	–5.9	–5.2
Home prices (existing homes)	3.0	2.9	–3.1	–6.0	–6.0	–6.1

Notes: ** 12-month averages of monthly data. ** Cumulative annual data. The figure reported for each year corresponds to the last period (quarter or month). The GDP growth data refer to year-on-year rates of change.*
Source: *BPI Research, based on data from Bloomberg.*

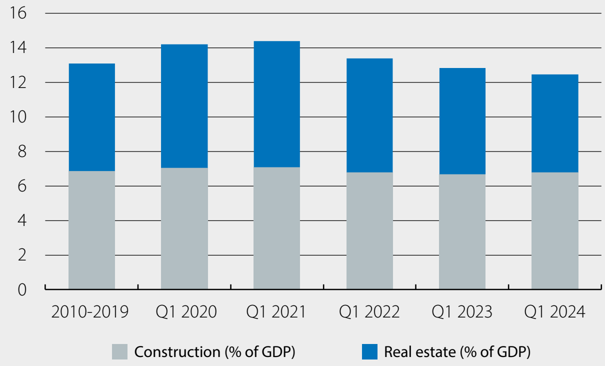
economy in the last decade, its weakness has diminished the Asian giant's growth outlook and has degenerated into a crisis of confidence. Faced with this scenario, and in a context marked by the country's structural slowdown, the authorities began to steadily relax regulations beginning in the second half of 2022.

Specifically, limits on the granting of new mortgages and on the purchase of housing were relaxed in 2023, and several incentive mechanisms were introduced to encourage developers to complete projects already underway.[1] All in all, these policies have led to a rebound in the number of finished construction projects, while the fall in new construction projects appears to have stabilised in recent months.[2] On the other hand, if we analyse the data on the total area that is under construction for different purposes, we can see how the fall in activity overall is far more modest than in the real estate sector specifically. The total area under construction by housing developers has fallen by 14% since 2021, while the total area under construction that also includes infrastructure, construction in rural areas and social housing has fallen by just 4%. Also, although residential activity in urban areas has fallen significantly in recent years, construction activity as a whole still shows a moderate adjustment, partly due to direct action by the authorities and their investment in infrastructure and social housing, as well as the fiscal measures introduced to support non-residential investment.

This dichotomy between the sharp adjustment on the demand side and the much more moderate adjustment on the supply side is illustrative that it will still take some time before the real estate crisis can be resolved. Thus, the slowdown has been much more acute in real estate than in the construction sector. In 2022 and 2023, the real estate sector registered negative year-on-year growth (of –3.9% and –1.3%, respectively), compared with an average growth of 5.4% between 2010 and 2019. In particular, real estate went from making a positive direct contribution of 0.3 pps to average GDP growth between 2010 and 2019 to making a negative contribution of –0.3 pps in 2022 and one of –0.1 pp in 2023 (the contribution of construction went from +0.6 pps to 0.2 pps and 0.5 pps in 2022 and 2023, respectively). Thus, the role of the real estate sector relative to the total economy has been steadily declining (see second chart).[3]

China: relative weight of the real estate and construction sectors in GDP

Value added of each sector (% of GDP)



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

A chronic patient, with a recommendation to go on a diet

The latest activity data suggest that the most acute phase of the housing crisis may now be behind us, but there is still a long way to go. In this context, it is important to highlight four key elements for monitoring the sector's future evolution.

Firstly, with demand at an all-time low, once the stock of housing currently under construction is exhausted, the adjustment in construction activity will intensify, and this could be reinforced by the slowdown that is expected in investment in infrastructure and in the industrial sector. Secondly, the rigidity observed in prices to date (new home prices have fallen by 6% or less since 2021 in the largest cities) makes the reduction in sales sharper and more prolonged, even if it may have limited the contagion to the banking sector. In this regard, further price declines in future could signal the willingness of the Chinese authorities to accelerate the adjustment process, but this would entail added risks for the banking sector and for household expectations. Thirdly, the international comparison suggests that the imbalances in the real estate sector tend to trigger long corrections, in terms

1. The most common financing model, based on pre-sales, made this a key element of the intervention in the real estate sector, particularly as an instrument to ensure social peace, given that in the event of a large developer's failure to comply, many households would find themselves in a highly vulnerable situation. In the last month, the Chinese authorities announced another series of support measures, with incentives for local governments to buy up housing stock not yet sold by developers and to allocate it for social housing. It is estimated that, between finished housing and construction in progress, developers may have between 1 and 2 billion m^2 of unsold housing on their balance sheets.

2. In the last 12 months, an average of 80 million m^2 of new housing has been built per month, while around 90 million m^2 per month has been completed. This contrasts with the average for the period 2010-2019, when 170 million m^2 of new housing was built per year, while the amount completed was also 90 million m^2.

3. «Construction» includes any activity related to the construction (or demolition) of homes, commercial spaces and infrastructure. «Real estate» encompasses all services related to housing, such as purchasing, rental, maintenance or consulting services.

of both their duration and their magnitude.[4] Furthermore, despite the fact that the construction sector accounts for a relatively small portion of China's GDP compared with other large economies, the limited adjustment observed to date and its capacity to generate significant knock-on effects suggest that the sector will continue to hold back the economy's growth in the medium term. Fourthly, it is important to stress that the situation is very different from region to region. For instance, the quarterly survey of construction companies reveals that, while the total area under construction in Beijing has increased by 15% since 2021, the reductions in other major cities, such as Hubei or Chongqing, exceed 15%. Also, the impact on local finances varies significantly between the different provinces and the fiscal capacity to respond to a protracted crisis in the sector will also be very different.

It seems that the Chinese authorities are managing to change the paradigm in the real estate sector and stabilise the first phase of the crisis. The adjustment on the demand side has been rapid, and a complete paralysis on the supply side has been avoided. However, this approach to tackling the issue is also delaying the resolution of what is a structural problem. China has gone from having virtually no private housing market in the early 1980s to a homeownership index of 90% today. This is one of the highest rates in the world, yet the country also has one of the highest rates of uninhabited housing, at around 20%. The next phase of the adjustment will thus present a more fundamental challenge: supply = demand.

Luís Pinheiro de Matos

4. China has had three years of adjustment, with a cumulative fall in prices of 10%. Although the experiences are very different, other historical examples with significant imbalances have led to longer adjustments. For example, the post-crisis financial adjustments in Spain and the US lasted between 5 and 7 years, with cumulative price declines in excess of 30%, while in Japan the real estate adjustment lasted almost two decades, with a cumulative drop in prices of around 50%. In addition, in the case of China, it is also important to highlight the significant differences between so-called Tier 1 cities, where there was a significant rebound in prices relative to income growth in the period 2010-2019, and Tier 3 cities, where the price increase recorded in the period 2010-2019 was far lower than in Tier 1 and 2 cities, and the problem seems to be focused in a chronic excess of supply.

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

UNITED STATES

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Activity									
Real GDP	1.9	2.5	2.4	2.9	3.1	2.9	–	–	–
Retail sales (excluding cars and petrol)	8.6	5.3	4.4	4.6	5.0	2.9	4.5	3.5	...
Consumer confidence *(value)*	104.5	105.4	105.4	109.0	102.7	106.3	103.1	97.5	102.0
Industrial production	3.4	0.2	0.0	–0.1	0.0	–0.2	0.1	–0.4	...
Manufacturing activity index (ISM) *(value)*	53.5	47.1	46.7	47.6	46.9	49.1	50.3	49.2	48.7
Housing starts *(thousands)*	1,552	1,421	1,455	1,380	1,481	1,403	1,287.0	1,360.0	...
Case-Shiller home price index *(value)*	307	312	308	316	321	324	325	...	...
Unemployment rate *(% lab. force)*	3.6	3.6	3.6	3.7	3.7	3.8	3.8	3.9	...
Employment-population ratio *(% pop. > 16 years)*	60.0	60.3	60.3	60.4	60.3	60.2	60.3	60.2	...
Trade balance[1] *(% GDP)*	–3.8	–3.1	–3.2	–3.0	–2.9	–2.8	–2.8	...	...
Prices									
Headline inflation	8.0	4.1	4.0	3.5	3.2	3.2	3.5	3.4	...
Core inflation	6.2	4.8	5.2	4.4	4.0	3.8	3.8	3.6	...

JAPAN

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Activity									
Real GDP	1.0	1.9	2.3	1.6	1.2	–0.2	–	–	–
Consumer confidence *(value)*	32.2	35.2	35.7	36.2	36.5	38.9	39.5	38.3	36.2
Industrial production	0.0	–1.4	0.9	–3.6	–0.9	–4.3	–3.1	–3.4	...
Business activity index (Tankan) *(value)*	9.5	7.0	5.0	9.0	13.0	11.0	–	–	–
Unemployment rate *(% lab. force)*	2.6	2.6	2.6	2.6	2.5	2.5	2.6	2.6	...
Trade balance[1] *(% GDP)*	–2.1	–3.0	–3.6	–2.7	–1.8	–1.2	–1.1	–1.0	...
Prices									
Headline inflation	2.5	3.3	3.4	3.1	2.9	2.5	2.7	2.5	...
Core inflation	1.1	3.9	4.2	4.3	3.9	3.2	2.9	2.4	...

CHINA

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Activity									
Real GDP	3.0	5.2	6.3	4.9	5.2	5.3	–	–	–
Retail sales	–0.8	7.8	10.7	4.2	8.3	4.7	3.1	2.3	...
Industrial production	3.4	4.6	4.5	4.2	6.0	5.8	4.5	6.7	...
PMI manufacturing *(value)*	49.1	49.9	49.0	49.7	49.3	49.7	50.8	50.4	49.5
Foreign sector									
Trade balance[1,2]	899	865	947	901	865	842	845.4	825.3	...
Exports	7.1	–5.1	–5.4	–10.8	–3.3	–1.7	–11.4	–1.0	...
Imports	0.7	–5.5	–7.0	–8.5	0.9	1.5	–1.9	8.4	...
Prices									
Headline inflation	2.0	0.2	0.1	–0.1	–0.3	0.0	0.1	0.3	...
Official interest rate[3]	3.65	3.45	3.6	3.5	3.5	3.5	3.5	3.5	3.5
Renminbi per dollar	6.7	7.1	7.0	7.2	7.2	7.2	7.2	7.2	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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Retail sales *(year-on-year change)*	1.2	–2.1	–2.3	–2.3	–0.8	–0.2	0.7	...	...
Industrial production *(year-on-year change)*	2.1	–2.1	–0.8	–4.7	–3.7	–4.6	–1.0	...	...
Consumer confidence	–21.9	–17.4	–26.9	–26.9	–26.9	–26.9	–14.9	–14.7	–14.3
Economic sentiment	102.1	96.4	96.5	96.5	96.5	96.5	96.3	95.6	96.0
Manufacturing PMI	52.1	51.2	44.7	43.2	43.6	43.9	46.1	45.7	47.3
Services PMI	52.1	52.1	54.4	49.2	48.4	48.4	51.5	53.3	53.2
Labour market									
Employment (people) *(year-on-year change)*	2.3	1.4	1.4	1.4	1.2	1.0	–	–	–
Unemployment rate *(% labour force)*	6.8	6.6	6.5	6.6	6.5	6.5	6.5	6.4	...
Germany *(% labour force)*	3.1	3.0	2.9	3.1	3.1	3.2	3.2	3.2	...
France *(% labour force)*	7.3	7.3	7.4	7.4	7.5	7.4	7.4	7.3	...
Italy *(% labour force)*	8.1	7.7	7.7	7.6	7.4	7.2	7.1	6.9	...
Real GDP *(year-on-year change)*	3.5	0.5	0.6	0.1	0.1	0.4	–	–	–
Germany *(year-on-year change)*	1.9	0.0	0.2	–0.1	–0.2	–0.2	–	–	–
France *(year-on-year change)*	2.6	0.9	1.1	0.7	0.8	1.1	–	–	–
Italy *(year-on-year change)*	4.2	1.0	0.6	0.6	0.7	0.7	–	–	–

Prices

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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
General	8.4	5.5	6.2	5.0	2.7	2.6	2.4	2.4	2.6
Core	3.9	5.0	5.5	5.1	3.7	3.1	3.0	2.7	2.9

Foreign sector

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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Current balance	–0.7	4.1	0.2	1.8	4.1	10.6	10.6	...	...
Germany	4.3	12.1	4.8	7.8	12.1	26.1	26.1	...	...
France	–2.0	–1.5	–1.8	–1.7	–1.5	–2.3	–2.3	...	...
Italy	–1.6	1.0	–1.1	0.1	1.0	4.2	4.2	...	...
Nominal effective exchange rate[1] *(value)*	**90.9**	**94.7**	**94.6**	**95.9**	**95.1**	**95.2**	**95.5**	**95.2**	**95.3**

Credit and deposits of non-financial sectors

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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Private sector financing									
Credit to non-financial firms[2]	6.7	2.7	4.0	1.1	0.1	0.3	0.4	0.3	...
Credit to households[2,3]	4.4	1.7	2.1	1.1	0.5	0.3	0.2	0.2	...
Interest rate on loans to non-financial firms[4] *(%)*	1.8	4.6	4.5	5.0	5.2	5.1	5.2	5.2	...
Interest rate on loans to households for house purchases[5] *(%)*	2.0	4.4	4.3	4.7	4.9	4.8	4.8	4.8	...
Deposits									
On demand deposits	6.3	–8.5	–8.1	–11.3	–10.7	–8.8	–7.5	–7.0	...
Other short-term deposits	4.5	21.1	22.5	23.2	21.0	18.4	16.7	15.7	...
Marketable instruments	3.7	20.4	22.0	20.4	19.8	20.1	19.3	22.6	...
Interest rate on deposits up to 1 year from households *(%)*	0.5	2.7	2.5	3.0	3.3	3.2	3.2	3.1	...

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 proves robust in the first few months of the year

The publication of the Q1 2024 GDP deta revealed quarterly growth of 0.8%, 0.1% higher than in the preliminary estimate. The economy benefited from the contribution of external demand, which added 1 percentage point (p. p.) to quarterly growth. Exports grew 1.6%, while imports contracted 0.6%. For its part, domestic demand detracted 0.1 p. p. from quarterly growth, as a result of the 3% drop in GFCF and the negative contribution (-0.2 p. p.) from inventories. The behaviour of GFCF is the result of two factors: i) postponement of investment decisions with a view to a stronger reduction in interest rates in the near future; ii) an environment of greater domestic uncertainty associated with early elections in March 2024. With regard to the contribution of stocks, their behaviour in Q1 may be indicative of an increase in production in Q2, which would strengthen activity in Q2 2024. In year-on-year terms, the economy grew 1.5%. The improved performance of GDP in Q1 and the expectation that the year will be marked by a trend from less to more resulted in the expected growth for the year being revised to 1.7%, 0.1% higher than the previous forecast. The risks for this new forecast are balanced, but with a slight upward bias.

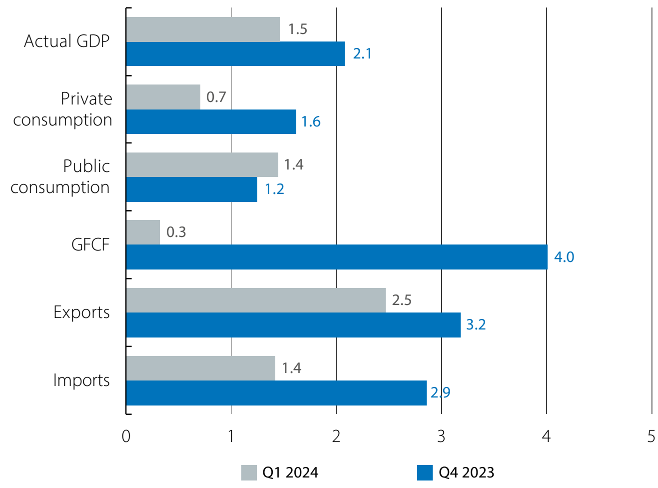
However, the most recent indicators suggest a good start to Q2. On the consumption side, retail sales rose 1.8% year-on-year in April and, excluding fuel, rose 2.8%, in both cases surpassing the average year-on-year growth recorded in Q1; and car sales remain buoyant, up 7.9% year-on-year in April. However, the consumer confidence indicator worsened slightly (0.2 points) in May, reflecting greater uncertainty about the future evolution over the next 12 months of the country's economic situation and of the possibility of making major purchases, But in the industry, construction and commerce sectors, confidence improved in the same month.

Inflation shock in May. Overall CPI rose significantly in May to 3.1%, up 0.9% on the April figure. It's the first time since September 2023 that it has been higher than 3%. In a way, this increase was already to be expected and is also the result of a base effect associated with the monthly price reduction recorded in May 2023 (-0.7%), following the VAT exemption on a number of essential foodstuffs. The underlying component also increased by 0.7% to 2.7%. Inflation in the Services sector is currently the main element in the drag on the inflation figure. Indeed, although we don't yet have the detail for May, in April the categories that are very intensive in Services (Hotels and restaurants, Communications, Health) contributed around 40% to the year-on-year change in prices. In the first four months of 2024 the Services sector accounted for an average of 83% of overall CPI figures and has proved highly persistent, above 4%.

The strength of the labour market supports economic growth. As the monthly data had been reporting, employment rose by almost 2% year-on-year in Q1, covering more than 5 million people. We need to go back to the end of 2008 to find a higher number. Job creation is mainly explained by construction, commerce and consultancy, scientific & technical activities, with job creation among younger people standing out (the 25 to 34 age group explains more than 50% of the year-on-

Portugal: demand elements

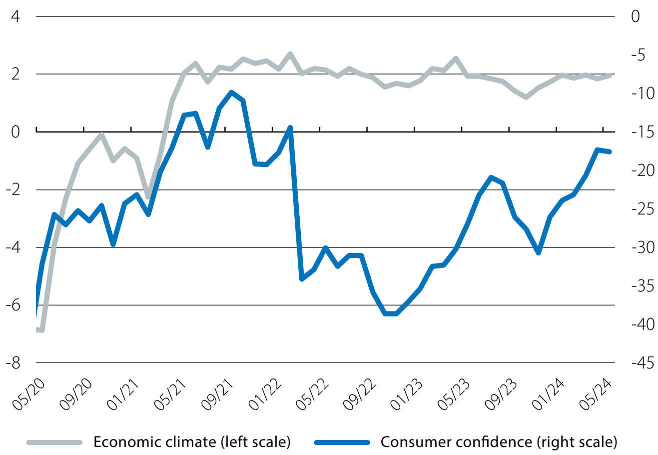
Year-on-year change (%)



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

Consumer confidence and economic climate

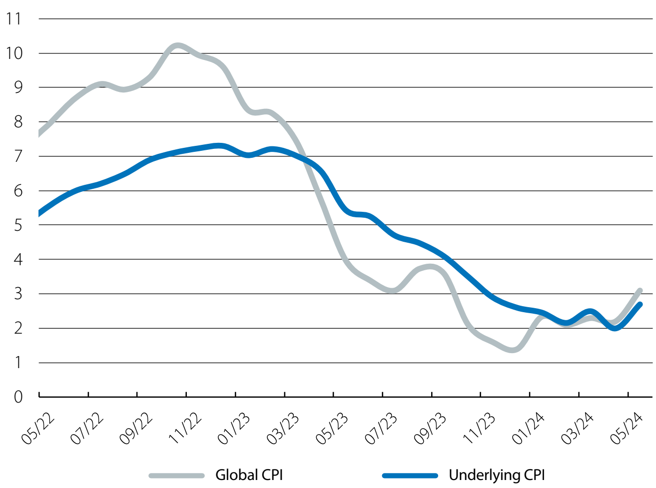
Year-on-year change (%) *(p. p.)*



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

CPI

Year-on-year change (%)



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

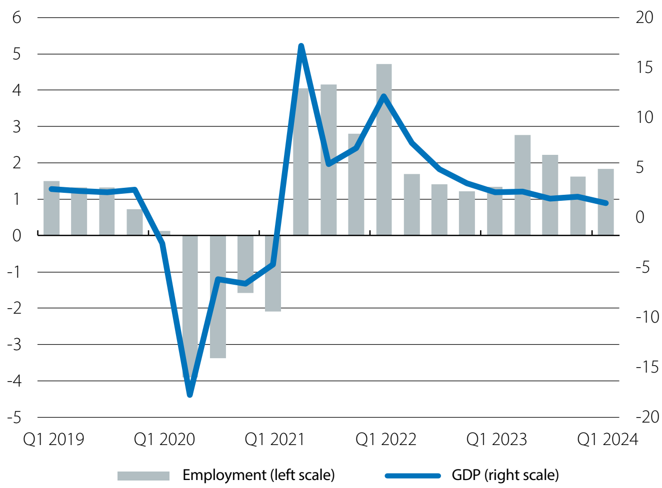
year increase in employment) and among people with higher levels of education. Another important aspect is the creation of jobs through open-ended contracts (in the face of a fall in employment on precarious contracts) and through full-time contracts. In this context, the unemployment rate fell year-on-year (6.8%, down from 7.2%). The most recent data corroborates our expectation that the labour market will continue to be a relevant factor supporting activity: employment fell very slightly in April (-0.4%) but the unemployment rate also fell to 6.3% (6.4% in March), while registered unemployment is falling for the third month in a row, remaining at historically low levels. The capacity to absorb the influx of active people into the labour market is likely to be decreasing, as evidenced by the evolution of job vacancies (around 30% below the historical average recorded in the months of April in the 5 pre-pandemic years).

Tourism weakens in April. Despite the increase in the number of guests and overnight stays compared to the previous month (both +14%), the modest performance of the Portuguese tourism sector in April becomes clear when we analyse the performance compared to the same month of the previous year. In fact, compared to April 2023, both guests and overnight stays fell: -3.7% and -4.3%, respectively. Only non-resident guests registered a positive number, although not significant (+0.2%). Naturally, just as the auspicious figures of March had been positively influenced, April's figures are negatively impacted by the moving structure of the calendar, i.e. the effect of the holiday period associated with Easter, which last year was concentrated in April, while this year it was spread between March and April. So, having lost the momentum of the post-pandemic rebound, the sector is likely to perform less exuberantly this year. All in all, performance this year is in line with what we projected: an overall increase in guests of around 5% (+4% up to April).

According to the Bank of Portugal, the vulnerabilities affecting the banking system have been reduced due to the improvement in economic conditions and because the maintenance of a gradual disinflation scenario contributes to the maintenance of positive economic activity. However, the main vulnerabilities continue to be geopolitical factors and the impact they could have on activity should their expansion lead to disruptions in distribution chains, price increases and further monetary tightening. Internally, the main risk factors continue to focus on debt levels, which although on a downward trend remain high. However, the credit portfolio continued to contract in April, but with increasingly smaller falls. Thus, in that month, credit to the private sector fell by 0.6% year-on-year, with credit to individuals growing by 0.1%, via consumer credit and a smaller contraction in mortgage credit. The expectation that house prices will continue to rise (albeit at a slower pace than in the past), the strength of household balance sheets and the recovery of purchasing power (with inflation under control and wages rising) should continue to support the current dynamics of mortgage lending, along with the expected reduction in interest rates. Indeed, the interest rate implicit in mortgage contracts fell, albeit slightly, for the third month running in April (-0.01% to 4.606%), which has mitigated slightly the year-on-year increase in monthly repayments.

Growth rate of employment and the economy

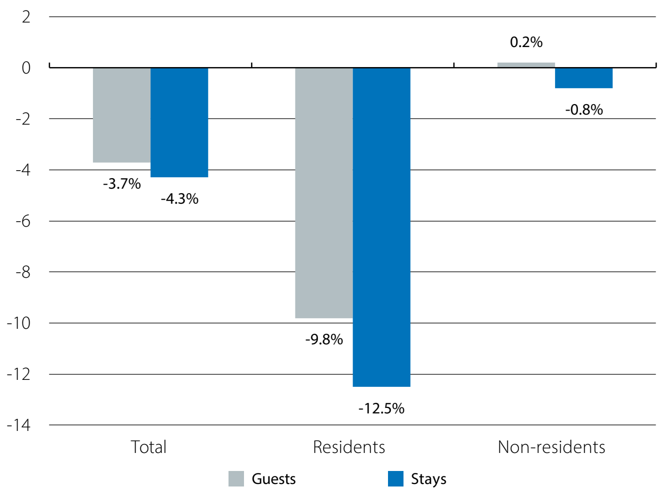
Annual rate of change (%) *(p. p.)*



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

Guests and overnight stays

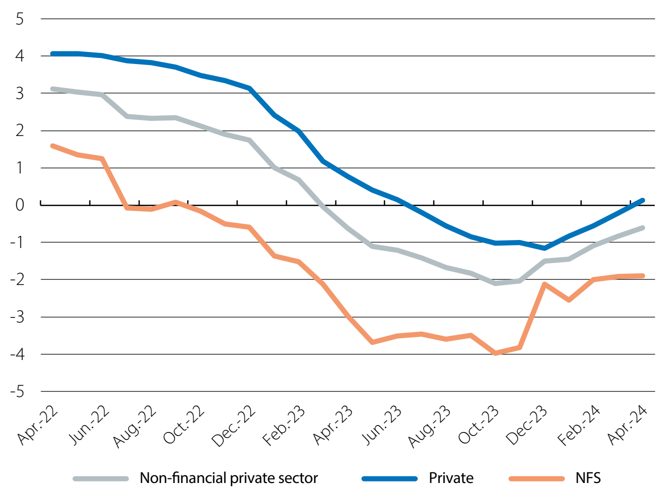
Variation in April 2024 compared to April 2023 (%)



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

Credit portfolio

year-on-year change



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

Adjustment to the macroeconomic outlook

At the end of May, we revised our central scenario for the main macroeconomic variables. This revision comes after the one we carried out in February and the changes made are not major, as we can see in the first table. In other words, the *big picture* hasn't changed, although the incorporation of the most recent data has been the main *driver* of the adjustments that we'll explain below.

Thus, the revision of the GDP growth outlook between 2024 and 2025 does not reflect a substantial change in Portugal's economic environment, just the incorporation of fresh data. The big change comes from the fact that the Q1 2024 figure (0.8% quarter-on-quarter, according to INE's flash estimate) was frankly better than we predicted at the start of the year: 0.4% *quarter-on-quarter* (see graph). According to the INE, the first quarter performance reflects a decrease in the positive contribution of domestic demand due to a fall in investment, while private consumption remained dynamic and accelerated compared to the last quarter of 2023. The fact that the Easter period was concentrated in March this year should also have favoured tourist activity in Q1 2024, as reflected in GDP. Data for Q2 2024 is still scarce, but seems to validate the idea of growth at a more contained pace. For example, in April, the economic climate indicator and the daily activity indicator grew year-on-year (1.7% and 2.2% respectively), but less strongly than they had done on average in the first quarter. Despite this significant difference in the strength of the Q1 data for the rest of the year, we anticipate a trend similar to previous forecasts, with a gradual evolution from "less to more" as the disinflation process progresses and monetary policy eases with the first official rate cut (which we expect to take place in June). This will be reflected not only in the financing costs and expectations of domestic economic agents, but also in demand from the eurozone's main trading partners.

In terms of prices, the slight upward revision to the average inflation rate in 2024 and 2025, delaying the 2% target to 2026, highlights the drag on the disinflationary process. It's a process that is not without its turbulence, as we saw in March when the underlying CPI broke a streak of 12 consecutive months of decline. Furthermore, there are months in which base effects may be felt more strongly, such as May,[1] since this was the month in 2023 in which the effects of Zero VAT were felt on a range of food products. There is mixed data on energy *commodities*: on the one hand, gas prices on the international markets are at relatively low and fairly stable levels due to a level of reserves above 2023 and historical averages; on the other hand, Brent Crude has registered prices above what we initially predicted at the beginning of the year. Although the relationship between supply and demand has not been strained recently, the geopolitical issues triggered by the start of the Israel-Hamas war always have the potential to disrupt the price of crude oil, given the relevance of the contenders and the data at stake: Iran is OPEC's fourth largest producer and more than 30% of the crude it exports by sea passes through the Straits of Hormuz and Bab-el-Mandeb. It's worth noting the persistence of inflation in Services as a whole, which account for more than 40% of the index and which, on average in the first 4 months of 2024, is above 4% year-on-year. In summary, our slight upward revision reflects the similarly upward revision for Brent Crude prices and leaves room for some more negative surprises in prices, although we believe that gradual normalisation will be the dominant trend.

New Macroeconomic Scenario

	2022	2023	2024	2025
GDP				
May 2024	6.8	2.3	1.7	2.3
February 2024	6.8	2.3	1.6	2.3
Inflation rate				
May 2024	7.8	4.3	2.5	2.1
February 2024	7.8	4.3	2.3	2.0
Property prices				
May 2024	12.6	8.2	4.3	2.4
February 2024	12.6	8.2	3.5	2.0
Unemployment rate				
May 2024	6.2	6.5	6.8	6.5
February 2024	6.2	6.5	6.7	6.5

With regard to the labour market, the adjustment in the forecasts was very slight, just a 0.1% increase in the unemployment rate in 2024 to 6.8%, *ceteris paribus*. This slight upward revision is essentially due to the more significant growth in employment and the labour force in Q1 compared to what we had expected, with the rate of growth being stronger in the labour force compared to employment. The labour market continues to perform well, which can be seen in the record number of people in employment at the end of March (over 5 million); in wages increasing at a faster rate than inflation since March 2023; and in the fact that the sector that created the most jobs in 1Q 2024 is pro-cyclical and labour intensive – civil construction. However, the slowdown in the economy compared to the previous year, combined

1. At the time of writing, we still don't know what the inflation rate was in May 2024, although we expect an increase on April's figure.

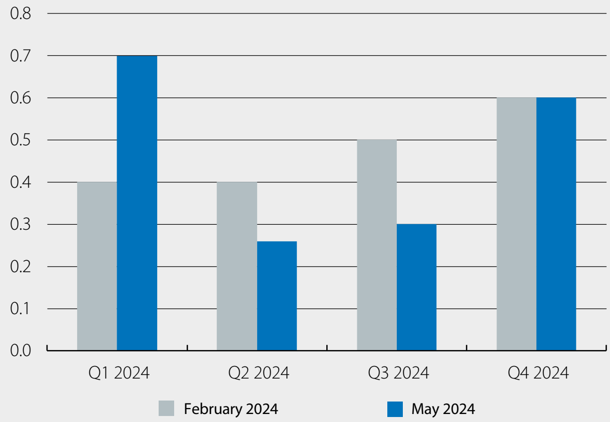
with positive migration balances and job vacancies below the peak (although still high), should result in a lower capacity to absorb workers.

Finally, the upward revision of the forecast for the Housing Price Index in 2024 and 2025. In the previous review, we still didn't have the data for the end of 2023, which turned out to be higher than projected. This brought with it a greater *carry-over* effect (0.4%), an extra 0.2%, which partially explains the upward revision in 2024 (from 3.5% to 4.3%). But more important than that is the data we already have at the start of the year. On average, prices rose by 0.7% every month in the first three months of this year, according to the residential price index drawn up by Confidencial Imobiliário (CI). Data from the same institution indicates growth in the number of property transactions both in quarterly terms compared to the last quarter of 2023 and in year-on-year terms. In bank valuations of housing released by INE, March saw the most significant monthly increase in the median value/m, to 1,580 euros). These good data come as a result of improved expectations: the quarterly CI indicator for sales showed a slight increase in the balance of extreme responses from +1% last month to +7% this month (the third consecutive month of positive readings after several months of negative readings). Like sales expectations, price expectations for the next 3 months have become more positive, with a net balance of +4% in the latest results. This is the first positive reading of near-term price expectations since April 2023. With a limited supply of property remaining and more confidence in the proximity of a rate cut, this market remains very resilient.

Tiago Belejo Correia

GDP forecast

Quarterly variation (%)



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

Tourism: how 2023 closed and how 2024 began

In 2023, the tourism sector in Portugal continued on its path to recovery, surpassing expectations and setting new highs in various parameters. For 2024 we expect the tone to remain good, but at one gear closer to cruising speed.

Multiple records set in 2023

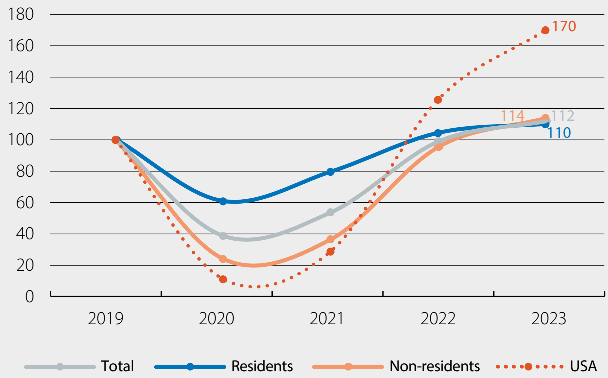
It's hard to name a metric in which historical levels weren't surpassed last year. Starting with the number of overnight stays (77.1 million) and guests (which passed 30 million). These figures are roughly double that of ten years ago and are a good testament to how the sector has grown.

Despite the sharp drop in the years of the pandemic, the country was one of those that showed the greatest capacity for recovery in terms of non-resident tourists, and other factors were also responsible for the performance in 2023: pent-up demand and excess savings accumulated from the pandemic period; the good dynamics of the US outbound market; and *one-off* events like World Youth Day, for example.

The evolution of overnight stays compared to 2022 was stronger for non-resident tourists (+15%) than for residents (+2%) and brought the *mix* of overnight stays back to the patterns seen before the pandemic (70% were made by non-residents and 30% by residents). All in all, resident guests exceeded the pre-pandemic level by 10% (they had already done so in 2022, by 4%) and non-residents did so for the first time, by 14%. Among non-residents, it's worth highlighting the extraordinary performance of the US outbound market in recent years, with the number of North American guests at a level 70% higher than pre-pandemic and as the third largest outbound market.[1] By type, almost 82% of overnight stays were in hotels, but overnight stays in local accommodation recorded the highest year-on-year growth (+16%, compared to 10% in hotels and 11% in rural tourism and housing). By region, the strongest year-on-year growth in overnight stays was in the North (+15%) and in Local Accommodation in Lisbon (+13%). Also at a regional level, it should be noted that in the Algarve, overnight stays by residents fell both compared to the pre-pandemic (–6%) and compared to 2022 (–7%), possibly due to the price factor[2] combined with competition from destinations with identical characteristics and geographically close to the south of Spain.

Financially, these figures translated into Total Revenue in tourist accommodation establishments totalling 6 billion euros. This represents nominal growth of +20.1%, which is also true in real terms (average annual global inflation in 2023 was 4.3% and inflation relating exclusively to accommodation services was 17.2%). When we look at the external accounts, it can be seen that the tourism balance for 2023 as a whole grew by 20.7% and made a positive contribution equivalent to 7.1% of GDP. Nevertheless, it is interesting to note that in the strongest tourist quarter (the third), the year-on-year growth in tourism imports was stronger than the growth in exports. This figure highlights the fact that resident trips abroad grew by 30.3% year-on-year in Q3 2023, compared to a –3.1% drop in trips within the country. We travel more in Portugal (86% of all trips by residents) but the rate of growth of Portuguese trips abroad in 2023 was higher than that of trips «within Portugal» (21.5% and 2.4% respectively). The main destinations for trips abroad were Spain (41.6%), France (10.1%) and Italy (6.9%).

No. Guests (residents vs non-residents)
Level (2019 = 100)



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

2024 begins timidly, but Easter helps the recovery

In the first quarter of 2024 there was an increase in the total number of tourists and overnight stays compared to the same quarter in 2023 (+7.7% and +7.1% respectively). These are notable increases given that the basis of comparison is 2023, but they mask some nuances in the first three months of the year. This is clearly visible in the fourth graph, which shows the variation in overnight stays in the first three months of the year compared to the same period of the previous year. In January the performance was very modest, the total number of overnight stays even fell compared to January 2023 (–0.3%) and the drop was more marked in overnight stays from residents (–3%). Performance improved throughout the quarter and in March both overnight stays from residents and non-residents were growing above 10% year-on-year. In part, this good performance was influenced by the moving structure of the calendar, i.e. the effect of the holiday period associated with Easter: this year the festive period was spread between March and April, while in 2023 it was only in April. Naturally, this translated into a lower bed occupancy rate in January

1. On this subject, see the article which appears in the Monthly Report for July 2023 «Back to the future: the new wave of tourists from the USA».
2. A historical RevPAR of 157.9 eur was achieved in August 2023.

Monthly Trips by destination
Thousands

Month	Total (no.)			Total Portugal (no.)			Total Foreign (No.)		
	2019	2022	2023	2019	2022	2023	2019	2022	2023
Total	**24,463**	**22,627**	**23,668**	**21,363**	**19,969**	**20,440**	**3,100**	**2,657**	**3,228**
January	1,501	1,373	1,570	1,313	1,275	1,423	188	97	148
February	1,539	1,538	1,781	1,363	1,401	1,529	176	137	252
March	1,634	1,431	1,502	1,422	1,261	1,352	212	170	150
April	2,060	1,972	2,177	1,739	1,666	1,873	321	306	304
May	1,539	1,456	1,546	1,356	1,282	1,334	184	174	212
June	2,001	1,901	1,933	1,677	1,641	1,636	323	260	297
July	2,607	2,565	2,523	2,304	2,294	2,192	303	271	330
August	4,122	3,614	3,685	3,595	3,206	3,136	527	408	548
September	1,939	1,778	1,806	1,705	1,549	1,502	234	229	305
October	1,443	1,270	1,297	1,278	1,103	1,130	165	167	166
November	1,555	1,350	1,266	1,365	1,188	1,080	190	161	187
December	2,524	2,381	2,583	2,246	2,103	2,252	278	278	331

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

(and also in February), recovering in March to the highest record in the series in that month (42%).

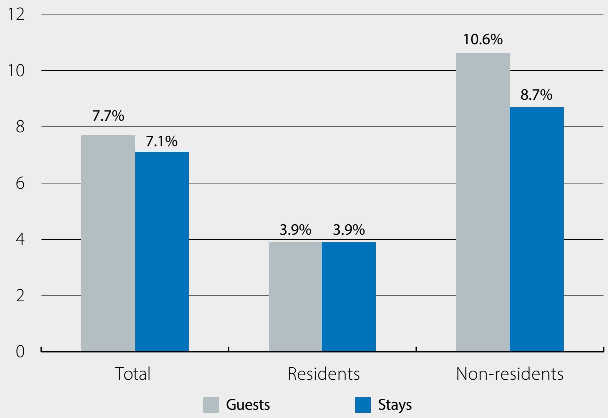
By region and by volume, the North and the Algarve showed the biggest increase in overnight stays in Q1 2024 compared to the same period last year; in terms of variation, the West and Tagus Valley region (+23%), the North (+10%) and the Centre (+10%) stand out. By source market, the biggest growth was in origin countries with less weight in the total, which emphasises the diversification of Portuguese tourism. Indeed, with guest growth of more than 20% compared to Q1 2023, we would highlight Ireland (23%), Denmark (25%), Poland (26%) and Canada (30%). On the downside, one of the most representative inbound markets was France (–7.1%). In terms of volume, the USA continues to stand out, with 41,600 more tourists.

Overall, the figures for the first quarter are in line with our vision of how tourism will evolve in 2024, with an expected increase in tourists of around 5%. The *rebound* effect of the post-pandemic recovery is exhausted, we are closer to the limit of installed airport capacity, and some caution remains on the part of travellers from the more central European markets with greater proximity to the conflict in Ukraine. On the other hand, the central macroeconomic scenario that rules out recession in the Eurozone (Portugal's main source markets for tourists) will continue to support the sector's growth in the country. This will be associated with some recovery in purchasing power via wage growth, lower inflation and lower interest rates. In Q2 2024, in April, the number of flights at national airports continued to surpass those of the previous year, which is a good indication for the times ahead.

In short, although these first figures of the year are broadly in line with what we anticipated, it remains to be seen whether the strong trend of March will continue or whether the modest performance of January and February will be more dominant.

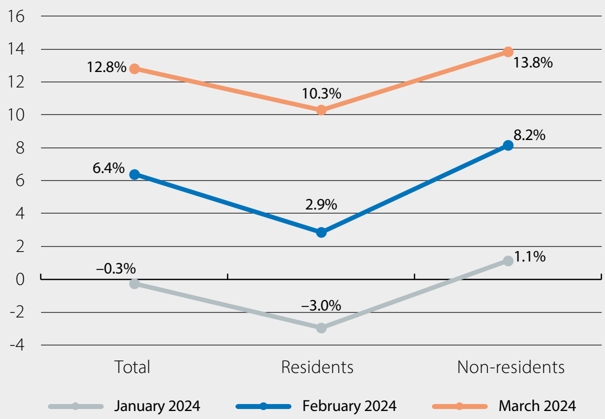
Tiago Belejo Correia

No. Guests and overnight stays
Variation Q1 2024 vs. Q1 2023 (%)



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

Number of overnight stays
Variation compared to the same month in 2023 (%)



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

We have turned the page on the budget outlook... what's next?

2023 was once again a surprising year for the Portuguese public accounts. The significant growth in revenue, well above expenditure, contributed to a surplus of 1.2% of GDP, a historic figure in the years of Portuguese democracy,[1] and significantly higher than the government's latest forecast in the 2024 State Budget (0.8%). The better than expected performance was explained by tax and social security revenue, which was more than 1.1 billion euros higher than expected, while expenditure was around 440 million euros lower than the last estimate, with lower than expected performance in the case of intermediate consumption, social benefits and investment. Despite this, the 2023 budget balance was affected by *one-off* measures that harmed the balance by around 0.5%, which would imply that the surplus had reached 1.7% of GDP if these measures had not existed.[2]

Another interesting aspect is the return to a certain normality post-pandemic, visible, for example, in the weight of primary current expenditure in GDP, a key indicator to analyse rigid public expenditure, which decreased compared to that recorded in 2019 (–0.3%). Another interesting aspect is that, despite the significant increase in interest charges in 2023 (+23.3%), their weight in GDP is still 0.8% below that recorded in 2019, and investment, despite being constantly over-budget, is close to 3% of GDP (it reached its highest weight since 2012, excluding the pandemic period). In addition, it is important to look at general government revenue. On this point, it is worth highlighting the 1% increase in the weight of total revenue in GDP, explained by tax and contributory revenue (whose increase in this period, of around 27%, exceeded the growth in nominal GDP, of around 24%) and also capital revenue, influenced by funds from the EU (namely those from the PRR). In this context, the primary balance remained in surplus and exceeded that recorded in 2019, while the public debt ratio was 17.5% lower than pre-COVID, reaching the lowest ratio since 2009.

The last few years have turned the page on the budgetary panorama, with the commitment to consolidating public accounts becoming the new normal. Therefore, against a backdrop of economic growth, a robust labour market and a slowdown in inflation towards the 2% target, we maintain a scenario of a slight budget surplus for the next 4 years.[3]

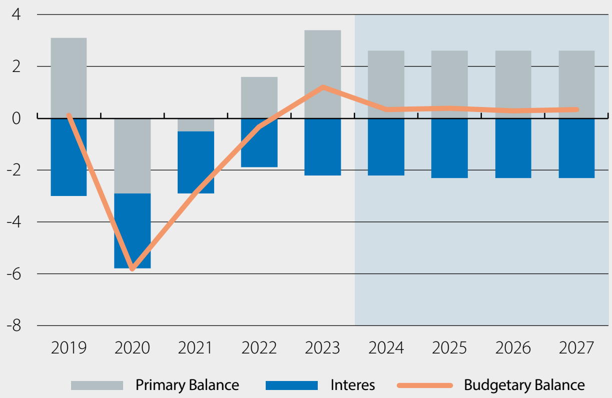
1. You have to go back to 1973 to find a surplus higher than the one recorded in 2023; at that time, the budget balance reached 1.5% of GDP.
2. CFP estimate, included in the document "Economic and budgetary outlook 2024-2028". Among these measures, the 916 million euros of additional losses on credits held by Parvalorem that cannot be recovered stand out, according to the same source of information.
3. The scenario presented in this article includes measures known at the time of the respective update; for example, the impact of the personal income tax relief measures (valued at around 1.3 billion euros), the measures included in the 2024 State Budget, and others included in the 2023-2027 Stability and Growth Programme (since the recent SGP was built on invariant policies and contains no new fiscal policy measures).

Main items in the public accounts
(% GDP)

	2019	2023	Variation 2023-2019
Current revenue	42.2	42.6	0.4
Tax and contributory revenue	36.6	37.5	1.0
Capital income	0.4	0.9	0.6
Total revenue	**42.6**	**43.5**	**1.0**
Personnel expenses	10.8	10.5	–0.3
Social benefits	18.1	17.5	–0.7
Interest	3.0	2.2	–0.8
Investment	1.8	2.6	0.7
Total expenditure	**42.5**	**42.3**	**–0.1**
Primary current expenditure *	**36.7**	**36.3**	**–0.3**
Overall Balance	**0.1**	**1.2**	**1.1**
Primary balance	**3.1**	**3.4**	**0.3**
Public debt	**116.6**	**99.1**	**–17.5**

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

Evolution of the Budget Balance
(% GDP)



Note: *BPI Research, projections for 2024-2027.*
Source: *BPI Research, based on data from the National Institute of Statistics.*

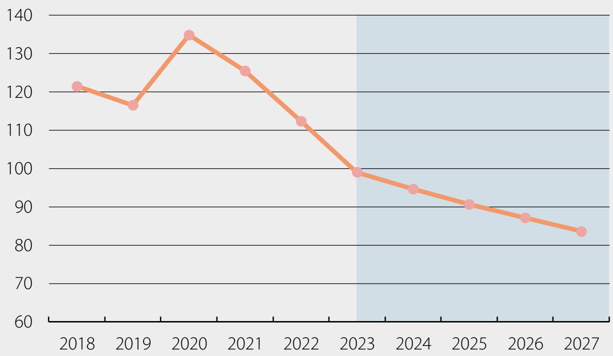
On the one hand, total revenue is expected to increase as a percentage of GDP in the coming years and is expected to reach a peak in 2026. This is because capital revenue will benefit from European funds, particularly those relating to the RRP, which means that its percentage of GDP will increase until 2025, stabilise at around 1.7% in 2026, and then fall to levels more in line with the figures recorded in the past (around 0.5%). In turn, tax and contributory revenue will benefit from the dynamics of economic activity and the strength of the labour market over the projection horizon, but the average annual growth rate is expected to be lower than that expected for nominal GDP, which implies a reduction in its weight in GDP over the next few years. This is in view of the expected implementation of tax relief measures, particularly in terms of personal income tax. Therefore, it should fall from the estimated 37.4% in 2024 to around 37% in 2027.

Expenditure will also increase its weight in GDP up to 2026, also due to the impact of the RRP on the budget balance, and then fall to less than 43% of GDP in 2027.[4] In this sense, capital expenditure will show a similar profile to capital revenue, increasing until 2025, stabilising at around 4.4% in 2026, and falling back to below 4% of GDP in 2027. In turn, personnel costs should practically stabilise at below 11% of GDP throughout the projection horizon, although budgetary pressure is to be expected from the updating of civil servants' salaries and other measures that may be taken and not incorporated in this scenario. At the same time, social benefits should evolve in line with the updating of pensions (according to the calculation formula), also reflecting the expected update of the Social Support Index as mentioned in the 2023-2027 Stability Programme and the impact on benefits that depend on this index.

Finally, interest charges will continue to rise over the projection horizon, albeit at a slower pace. In this sense, the interest burden should increase to 2.3% of GDP in 2025 and should remain so in the following years. This trajectory reflects the increase in financing costs on the markets, with the interest rate on 10-year Portuguese government bonds expected to exceed 3% throughout the projection horizon. Even so, the weight of interest on GDP compares favourably with the 3.0% recorded in 2019, before the pandemic and when financing costs were substantially lower. In a very simplistic exercise, should the interest rate on 10-year TBs reach twice what we are expecting (which would imply financing costs similar to those of 2013), the implicit interest rate would exceed 4% at the end of the horizon (compared to 2.8% in the current scenario) and its weight in GDP would be similar to that recorded in 2018. Despite this, and everything else remaining equal, the budget balance would reach deficits of less than 1% of GDP, and the public debt ratio would be around 86% in 2027 (compared to the current scenario of less than 84%). Even in this scenario, the two safeguards enshrined in the new European budget rules (deficit and debt) would not be jeopardised.[5]

Meanwhile, the known budget implementation for Q1 2024 points to a deficit of 0.4% of GDP, with revenue increasing far less than expenditure. However, it's still too early to draw clear conclusions about the 2024 implementation. Indeed, the beginning of the year always brings greater complexity when compared to the previous year, given the different expenditure payment profiles and/or receipt of revenue. For example,

Evolution of the Portuguese public debt ratio
(% GDP)



Note: *BPI Research projections for 2024-2027.*
Source: *BPI Research, based on data from the National Institute of Statistics.*

compensation of employees and current transfers are increasing significantly year-on-year, and one of the reasons for this is the year-on-year comparison adversely affected by the extraordinary updating of salaries and pensions in May and July 2023, respectively.[6]

Despite a scenario that seems more encouraging for public accounts than in the past, risks continue to lurk. In addition to all the risks associated with the macroeconomic scenario (namely the possibility of a sharp slowdown in the economy, a worsening of the labour market, a scenario of greater uncertainty, very weak tourism or reduced implementation of the RRP), there are also budgetary risks, i.e. those arising from budgetary policy decisions or circumstances. These include the budgetary pressures arising from the updating and revision of civil service careers, and the updating and other measures on the pensions and other elements of social support, some of which are apparently going ahead, but without cost estimates. In addition to these we might add pressure for greater investment in the defence sector (in order to achieve the NATO commitment of 2% of GDP) and other measures that may emerge to mitigate other adverse events (for example, measures to mitigate the effects of drought).

Although the scenario presented in this article does not incorporate these negative risks, highlighting them and preparing public finances for their possible emergence is fundamental to maintaining the budgetary commitment.

Vânia Duarte

4. It is important to bear in mind the differences in the accounting of funds from the RRP and their impact on public accounts. As explained by the CFP, grants respect the principle of neutrality of European funds: this portion is recorded as public revenue and, conversely, as an expense associated with an investment. However, this principle does not apply to loans, as these are not accounted for as capital income, but will be accounted for on the expenditure side, when the respective investment is carried out. In this sense, the loan component also contributes to the increase in public debt.
5. For more information on fiscal rules, see the focus "New year, new European budget rules: Portugal in focus", in IM03/2024.

6. For example, if we adjust the growth in current transfers for this and other smaller factors, the budget balance would have been around 700 million euros (around 1% of GDP), with everything else remaining constant.

Activity and employment indicators

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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Coincident economic activity index	5.7	3.2	3.6	3.3	2.6	2.1	2.0	1.9	...
Industry									
Industrial production index	0.8	–3.1	–5.4	–4.5	–3.5	1.4	4.0	5.2	...
Confidence indicator in industry *(value)*	–3.4	–7.4	–5.9	–9.0	–9.3	–7.9	–7.1	–6.8	–6.8
Construction									
Building permits - new housing (number of homes)	6.2	6.0	1.4	9.7	2.3	–23.1	–42.2	...	...
House sales	1.3	–18.7	–22.9	–18.9	–11.4	...	–	–	–
House prices *(euro / m² - valuation)*	13.8	9.1	9.1	8.1	6.4	5.9	6.5	7.0	...
Services									
Foreign tourists *(cumulative over 12 months)*	158.9	19.1	52.6	24.9	19.1	13.1	13.1	11.0	...
Confidence indicator in services *(value)*	15.2	7.6	12.4	5.8	1.7	6.3	7.0	6.4	5.0
Consumption									
Retail sales	5.5	1.1	1.8	0.6	0.6	1.9	2.2	0.5	...
Coincident indicator for private consumption	3.9	2.4	2.7	2.7	2.1	2.1	2.2	2.5	...
Consumer confidence index *(value)*	–29.7	–28.6	–29.4	–22.8	–27.2	–24.6	–22.6	–20.4	–18.5
Labour market									
Employment	2.3	2.0	2.8	2.2	1.6	1.8	2.2	1.5	...
Unemployment rate (*% labour force*)	6.2	6.5	6.1	6.1	6.6	6.8	6.4	6.3	...
GDP	**6.8**	**2.3**	**2.6**	**1.9**	**2.1**	**1.5**	**–**	**–**	**–**

Prices

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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
General	7.8	4.4	4.4	3.5	1.7	2.2	2.3	2.2	3.1
Core	5.6	5.1	5.7	4.4	3.0	2.3	2.5	2.0	2.7

Foreign sector

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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	23.2	–1.1	11.8	3.0	–1.1	–5.0	–5.0	...	...
Imports *(year-on-year change, cumulative over 12 months)*	31.7	–4.2	12.5	1.1	–4.2	–7.5	–7.5	...	...
Current balance	**–2.8**	**3.6**	**1.5**	**4.1**	**3.6**	**5.1**	**5.1**	**...**	**...**
Goods and services	–4.7	3.3	–0.3	2.1	3.3	4.6	4.6	...	...
Primary and secondary income	1.9	0.4	1.9	2.0	0.4	0.5	0.5	...	...
Net lending (+) / borrowing (–) capacity	**–0.5**	**7.2**	**4.5**	**7.3**	**7.2**	**8.8**	**8.8**	**...**	**...**

Credit and deposits in non-financial sectors

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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Deposits [1]									
Household and company deposits	6.4	–2.3	–2.1	–2.6	–2.3	2.7	2.7	3.5	...
Sight and savings	7.3	–14.8	–9.0	–9.4	–14.8	–11.2	–11.2	–10.3	...
Term and notice	5.2	14.8	7.5	6.9	14.8	20.2	20.2	20.9	...
General government deposits	12.4	–12.4	1.4	5.5	–12.4	9.1	9.1	3.6	...
TOTAL	**6.5**	**–2.6**	**–2.0**	**–2.4**	**–2.6**	**2.9**	**2.9**	**3.5**	**...**
Outstanding balance of credit [1]									
Private sector	1.7	–1.5	–1.2	–1.8	–1.5	–0.8	–0.8	–0.6	...
Non-financial firms	–0.6	–2.1	–3.5	–3.5	–2.1	–1.9	–1.9	–1.9	...
Households - housing	3.2	–1.5	0.1	–0.9	–1.5	–0.8	–0.8	–0.5	...
Households - other purposes	2.9	0.2	0.4	–0.8	0.2	2.0	2.0	2.5	...
General government	–2.7	–5.5	0.6	–1.4	–5.5	5.9	5.9	–1.4	...
TOTAL	**1.6**	**–1.7**	**–1.1**	**–1.8**	**–1.7**	**–0.6**	**–0.6**	**–0.6**	**...**
NPL ratio *(%)* [2]	**3.0**	**2.7**	**3.1**	**2.9**	**2.7**	**...**	**–**	**–**	**–**

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

Spain's economic activity remains buoyant

The Spanish economy continues to show greater buoyancy than had been expected at the start of the year, thanks above all to the momentum of the tertiary sector, especially tourism-related activities, as well as the strength of job creation. In addition, over the coming quarters supporting factors will emerge, such as a less restrictive monetary policy, an easing of inflationary tensions and an expected acceleration in the execution of the European NGEU funds.

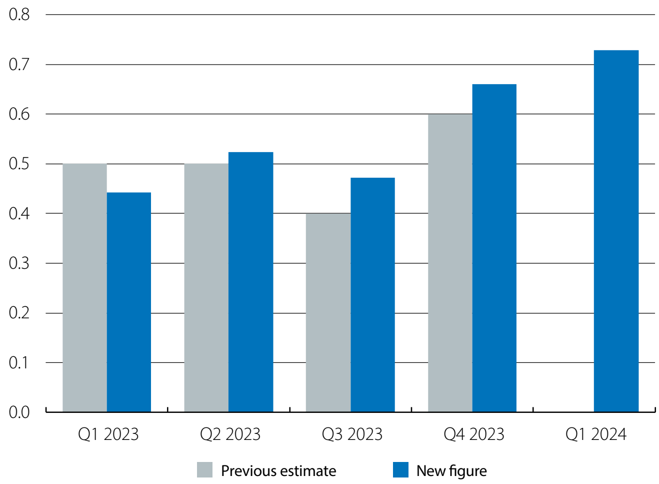
The surprising GDP growth figure for Q1 2024 (0.7% quarter-on-quarter, a rate that far exceeds that of the euro area), combined with the vigour observed in the indicators available for Q2 (PMI, employment, consumption, etc.), confirms the good tone of the Spanish economy. We must also consider the positive impact that the upward revision of GDP growth in the last three quarters of 2023 will have on growth in 2024. All this leads us to raise our growth forecast for the current year by 0.5 points to 2.4% (see the Focus «New economic outlook: Spain's economy once again surpasses expectations» in this same report).

The indicators available for Q2 offer positive signals and indicate that the economy continues to grow at a steady pace. The PMI business climate survey for the services sector stood at 56.9 points in May (56.2 in April), which is well above the level that marks expansion (50 points) and marks a peak since April 2023. Within the tertiary sector, the exceptional performance of tourism continues to stand out: in April, 7.83 million tourists arrived, which is 8.3% more than in April last year, and they spent 9.565 billion euros, the highest figure in the series in that month, hinting at a new record year for the sector. As for the manufacturing sector, its revival is consolidated, with its PMI standing within expansionary territory for the fourth consecutive month, reaching 54 points, which is 1.8 points more than the previous month and the highest level since March 2022.

The consumption-related indicators also offer positive signals. On the one hand, the retail trade index in real terms, corrected for seasonal and calendar effects and excluding service stations, grew by 0.8% month-on-month in April, compared to an average monthly fall of 0.2% in Q1. Also, according to the CaixaBank Consumer Indicator, Spanish bank card usage recovered in May, following the cooling of the previous month. Specifically, it grew by 4.4% year-on-year (with data up until the 21st), exceeding the 3.2% recorded in April and similar to the pace of Q1 (4.3%).

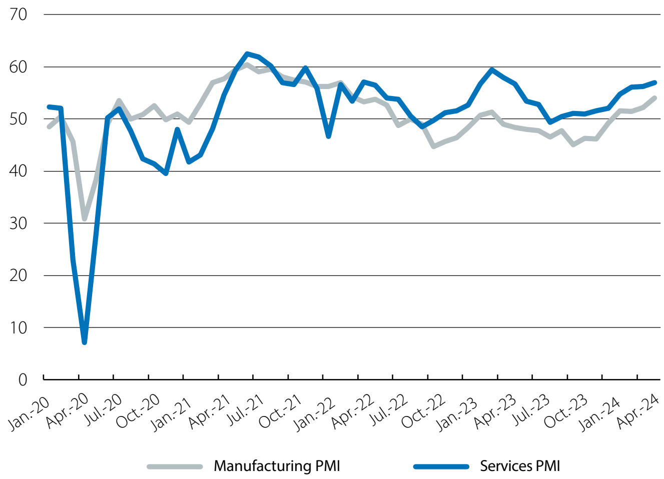
Employment remains solid and marks a new high in May. The number of registered workers increased by 220,289 people in May, improving on the figure for May last year (200,411) and the pre-pandemic average for the same month (213,582 in the period 2014-2019), and bringing the total number of registered workers to over 21.3 million. With seasonally adjusted data, employment increased in the month

Spain: GDP
Quarter-on-quarter change (%)



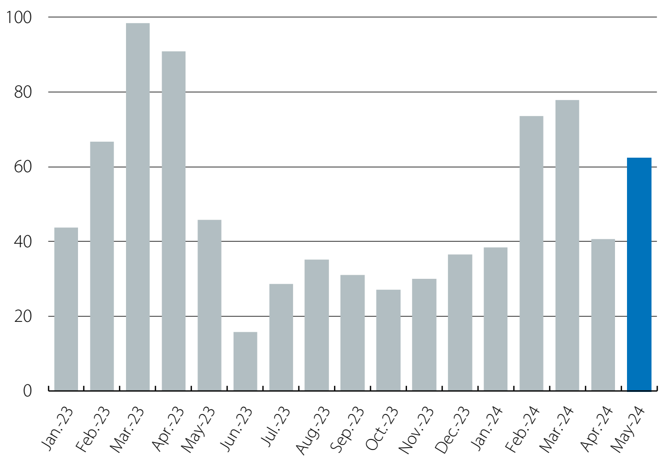
Source: *BPI Research, based on data from the National Statistics Institute (INE).*

Spain: PMI
Level



Source: *BPI Research, based on data from S&P Global PMI.*

Spain: registered workers affiliated with Social Security *
Month-on-month change (thousands of people)



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

by 62,505 workers, in line with the monthly average for Q1 (63,242); in Q2 to date, the quarter-on-quarter growth in the number of registered workers remains at 0.7%.

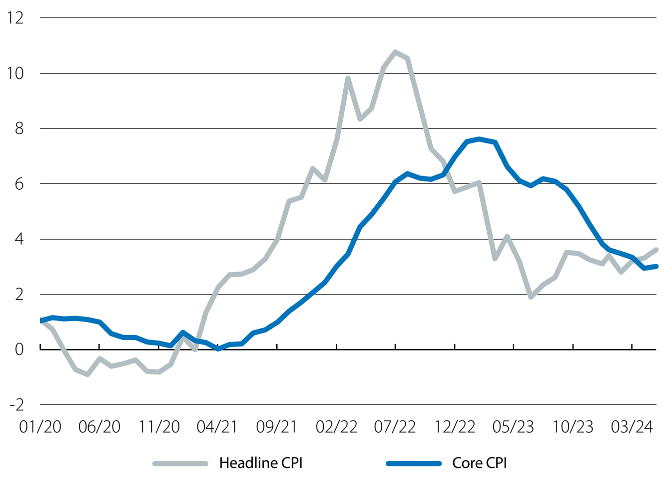
Inflation picks up again in May, but driven by non-core components. According to the CPI flash indicator published by the National Statistics Institute (INE), headline inflation increased in May for the third consecutive month, climbing 10 pps to 3.6%, which is the highest rate since April 2023. This rebound is due to the rise in electricity and fuel prices, which decreased to a lesser extent than in May in 2023: the upward contribution from energy is due to increases in the various taxes that apply to electricity bills. As for core inflation, which excludes energy and unprocessed food, it truncated its downward path of previous months and rose slightly to 3.0% (2.9% in April), due to a calendar effect influencing the price of services (Easter Week in 2023 was celebrated in April and this year, in March). In short, the rebound in inflation in May is due to specific factors and is within expectations, so it does not introduce any upside risks for our forecasts of a steady moderation over the coming months.

Home prices grow faster than expected in Q1. The home price index produced by the INE stood at a peak in the available series since 2007, after rebounding 2.6% quarter-on-quarter in Q1, which raises the year-on-year rate of change to 6.3% (4.2% previously). This acceleration in prices is occurring across all types of housing, although new homes are showing higher year-on-year growth rates than existing homes (10.1% versus 5.7%), reflecting a greater imbalance between supply and demand in this segment. By region, they all registered an acceleration in their year-on-year rate compared to Q4. Andalusia stands out as the market where home prices have risen the most in this early part of the year (7.9% year-on-year), compared to regions such as Castilla-La Mancha, Galicia or Asturias, where the growth rate is more moderate, at around 5%.

Deterioration of the trade deficit in Q1 2024 due to weak exports of non-energy goods. The trade deficit stood at 8.105 billion euros in Q1, surpassing the figure of a year earlier (–6.578 billion) and the average for the first quarters in the period 2014-2019 (–6.760 billion). This increase in the deficit is explained by the deterioration of the balance of non-energy goods, as the energy deficit remained fairly stable. Specifically, the balance of non-energy goods posted a surplus of 9 million euros, in contrast to the positive balance of 1.639 billion in the same period of 2023; this was due to a fall in exports, which were weighed down mainly by lower sales of medicines and organic chemicals (–7.2% year-on-year, corresponding to a 6.9% fall in volume and a 0.3% drop in prices), which was more intense than the decline in imports (–5.5%, with a 3.8% decrease in volume and a 2% decline in prices). The energy deficit, meanwhile, fell very slightly from 8.218 billion in Q1 2023 to 8.114 billion this year: exports fell by 28.2% (–21.9% in volume, with prices falling by 8.4%), which was more than imports, which fell by 15.3% (–12.3% in volume and –3.6% in terms of prices).

Spain: CPI

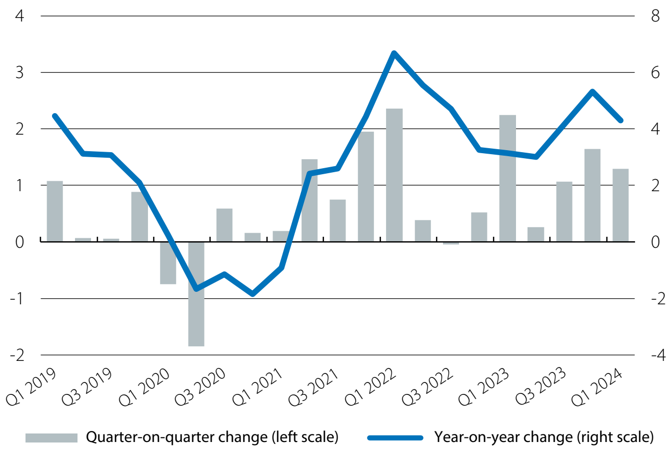
Year-on-year change (%)



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

Spain: home prices (appraisal value)

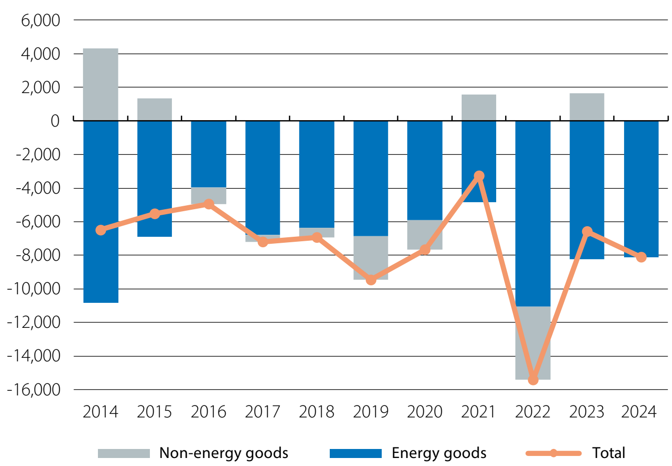
Quarter-on-quarter rate of change (%) — *Year-on-year rate of change (%)*



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

Spain: balance of trade in Q1

(EUR millions)



Note: *Data according to the Standard International Trade Classification (SITC).*
Source: *BPI Research, based on data from the Customs Department.*

New economic outlook: Spain's economy once again surpasses expectations

The Spanish economy has once again exceeded our expectations in the opening months of 2024. While the GDP growth figure for the final quarter of 2023 was higher than expected, that of the first quarter of this year confirms the good performance of Spain's economy and leads us to revise our forecasts upwards. Let's re-examine the main factors that will determine the outlook for Spain's economy, after incorporating the latest available information.

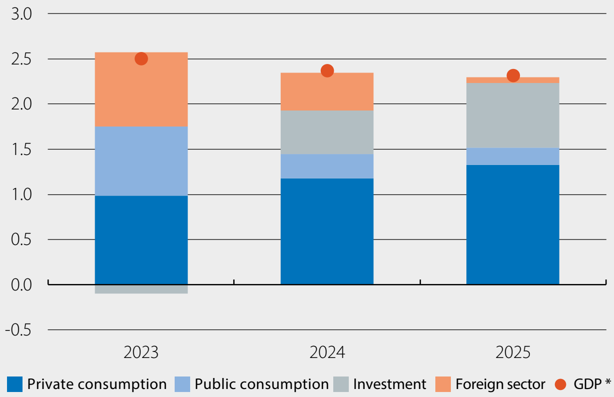
Starting point

The performance of Spain's economy provided a positive surprise for the second consecutive quarter, growing by 0.7% quarter-on-quarter during Q1 2024. This better-than-expected performance comes in addition to the upward revision of the figure for the final quarter of 2023, when GDP also grew by 0.7% quarter-on-quarter. Thus, the Spanish economy has managed to maintain a steady growth rate despite the multiple factors it has had to contend with, such as the weakness of the euro area economies, persistent inflation and the impact of the interest rate hikes, which were expected to peak in Q1 2024. Underlying this good performance are several key factors: the strength of the labour market, the boost provided by immigration flows, which remain dynamic, and the buoyancy of international tourism, which once again exceeded expectations and explains the strong contribution of foreign demand to growth. In contrast, domestic demand has maintained a more modest pace of progress. In the case of investment, although it rebounded significantly in Q1 2024, it remains 2.2% below the level of Q4 2019, and private consumption is just 0.4% above, despite the fact that the population has increased by 3% since 2019.

On the other hand, inflation, which has averaged 3.3% between January and May this year, has behaved in line with our expectations, albeit with some nuances when we go into the detail of the different components. In recent months, opposing dynamics between the various components of the CPI basket have been accentuated. On the one hand, core inflation, which excludes energy and food, has gradually fallen to 2.7% in May (4.4% in 2023), despite persistent inflation in services. On the other hand, the rest of the components continue to show relatively high inflation rates. The rise in energy inflation is mainly due to temporary factors: although the price of electricity in the wholesale market has remained relatively low, the final price has been affected by increases in the various taxes that apply to electricity bills. In the case of food, inflation rates are well below those of last year (4.6% year-on-year in April vs. 11.1% on average in 2023), but this decline is largely due to base effects. With month-on-month increases still above the average of the period 2015-2019, food inflation remains far from normalised.

Spain: GDP

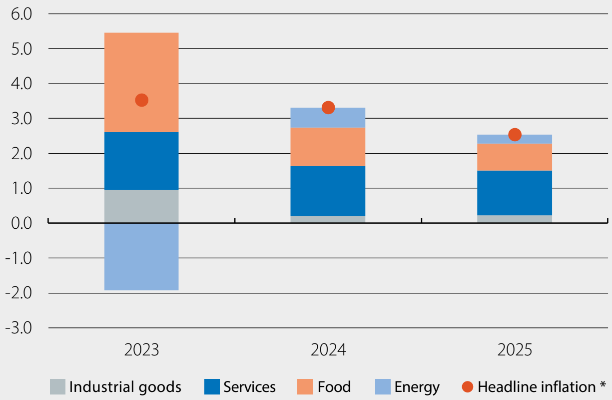
Contribution to annual growth (pps)



Note: ** Year-on-year growth in percentage terms.*
Source: *BPI Research, based on data from the National Statistics Institute (INE) and internal forecasts.*

Spain: inflation

Contribution to annual growth (pps)



Note: ** Year-on-year growth in percentage terms.*
Source: *BPI Research, based on data from the National Statistics Institute (INE) and internal forecasts.*

Revision of the underlying assumptions of the scenario

In the international scenario, the main assumptions of two months ago regarding the outlook remain in place. For the euro area, where economic growth is still weak and average inflation has been 2.5% up until May, we maintain our forecast of four rate cuts in 2024 (bringing the depo rate to 3.0% in December 2024), followed by three more in 2025. As such, monetary policy will continue to favour the recovery of investment. In terms of the price of the main commodities, the upward revision of the price of Brent oil to an average of 87 dollars/barrel in 2024 (79 dollars/barrel in the previous scenario) means that fuels will no longer contribute to the decline in inflation. However, the impact of this revision is relatively moderate, as oil already experienced a peak in prices during the second half of 2023.[1]

Outlook

The good data for this year's Q1, together with a somewhat more favourable global environment, lead us to revise upwards our GDP growth forecast for 2024 as a whole to 2.4% year-on-year and for 2025, to 2.3% year-on-year (0.5 and 0.1 pps more than in the previous scenario, respectively). Beyond the aggregate data, this revision is accompanied by a change in the pattern of growth. Firstly, we expect domestic demand to take over from foreign demand as the driver of growth, in light of the expected cooling of exports of goods and the anticipated normalisation of tourist flows.[2] In turn, we also expect that domestic demand will be less driven by public consumption and that we will see a gradual revival of both private consumption and investment.

On the private consumption side, the good data on job creation and population growth have resulted in a sharp increase in household gross disposable income (GDI), which rose by 11.0% year-on-year in 2023. This increase in GDI has placed the savings rate at 11.7%, above the historical average of 8.2%.[3] Given the anticipated interest rate cuts on the part of the ECB, we expect a portion of these savings to contribute to an increase in private consumption, which would improve the growth rate to 2.2% in 2024 (1.7% in 2023) before accelerating to 2.4% in 2025. In terms of investment, our forecast is that it will begin to gain momentum with a growth rate of 2.5% in 2024, spurred on by the first interest rate cuts on the part of the ECB and by greater traction in the execution of the NGEU funds, the maximum disbursement of which is expected to take place in 2025.

The good outlook in our scenario is not limited to economic activity growth. In line with the upward revision of GDP and the good performance of employment so far this year, we have revised our forecast for the unemployment rate down to 11.6% on average in 2024 and to 11.1% in 2025 (0.2 and 0.3 pps less than in the previous scenario, respectively). This forecast is relatively moderate given that we have also revised the growth of the labour force upwards in the face of immigration flows that are still projected to be high.

On the other hand, the real estate market will continue to benefit from the low level of leverage among households at the aggregate level and the resilience of foreign demand, in addition to the robust labour market and the decline in interest rates. In this regard, we have also revised upwards our forecast for the annual number of home sales to 565,000 (15,000 more than in the previous scenario) and, above all, we have raised our forecast for the growth of home prices to 4.0% year-on-year (1.3 pps more than in the previous scenario).

As for inflation, we have revised our forecast for 2024 slightly upwards to an annual average of 3.2% (0.2 pps higher than in the previous scenario). The main factors behind this revision are a slightly worse than expected pattern of inflation in food and the rise in VAT on electricity due to the low wholesale market prices.[4] On the other hand, we maintain the forecast of a decline in core inflation, which would average 2.7% year-on-year in 2024 (4.4% in 2023), although it will be marked by a degree of persistence in the case of inflation in services.

The risks surrounding the new forecast scenario are high. On the one hand, private consumption could benefit from a somewhat faster normalisation of the savings rate than we expect, and investment could recover quicker than expected as interest rates come down. In addition, immigration flows and the growth in spending by international tourists could remain higher than anticipated. As for the downside risks, they are mainly geopolitical in nature. At the international level, a potential escalation of the conflict in the Middle East could drive up the price of oil and reverse the moderation process in inflation, with the consequent impact on economic activity. At the national level, it is important that the execution of the NGEU funds gains traction in order to support the recovery of business investment.

1. See the Focus «The buzzword in the new international scenario: divergence» in this same *Monthly Report*.
2. See the article «Which of Spain's sectors have been hardest hit by the slowdown of the country's trading partners?» in the *Sectoral Observatory*.
3. See the Focus «A closer look at the increase in Spanish household savings in 2023» in the MR05/2024.
4. In March, VAT on electricity temporarily rose to 21% (from 10%) as electricity prices in the wholesale market fell below the threshold of 45 euros/MWh. Right now, the futures markets are anticipating an increase in the wholesale price of electricity above the threshold, which would cause VAT to drop back down to the reduced rate in the summer through to January 2025.

CaixaBank *Sector Observatory*: a look at the evolution of the Spanish economy from the perspective of its sectors

In this Focus we present the main conclusions of the *Sector Observatory*, a new publication by CaixaBank Research in which we offer a clear and detailed analysis of the evolution of the Spanish economy from the point of view of its sectors. To this end, we have developed a new tool, the CaixaBank Research Sector Indicator, which allows us to track the evolution of 24 sectors in the spheres of economic activity, the foreign sector and the labour market. This indicator allows us to visualise the health of the various sectors in Spain and where they lie in the cycle, making it easier to assess their future outlook at the individual level.[1]

From the dispersion of economic activity following the pandemic...

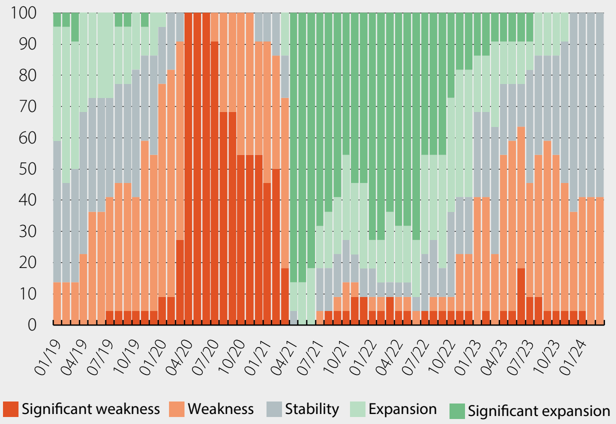
Thanks to the new indicator, we observe that the major shocks the Spanish economy endured between 2020 and 2023 have had a widely varying impact on the different sectors, which increased the degree of dispersion between them in the pattern of economic activity:

- The COVID-19 pandemic in 2020 caused a sharp and widespread fall in economic activity, especially in the sectors most dependent on social interaction: leisure and entertainment, catering and accommodation. Subsequently, the rapid and intense recovery generated significant rebounds in activity.
- The bottlenecks in global value chains that followed beginning in 2021 dealt a blow to the manufacturing industry, especially the automotive sector.
- The war in Ukraine and the energy crisis in 2022 drove up production costs, which had a more severe impact on the most energy-intensive branches of industry: the agrifood sector (primary and processing industries), the extractive industry, the construction auxiliary industry, textile and footwear, paper and refining were the branches that were hardest hit.
- Finally, the increase in interest rates since mid-2022 harmed the sectors that are most dependent on external financing, such as real estate and some branches of industry.

...to a gradual homogenisation of the performance among the sectors

As these shocks have been gradually absorbed, the performance of the various sectors is becoming increasingly homogeneous. Our sector traffic light chart shows that, in the first few months of 2024, around 60% of the sectors have maintained stable growth.[2] Furthermore, our analysis of the indicators in the different spheres (economic activity, the labour market and the external sector) allows us to conclude that the strength of the labour market is the primary factor behind the resilience shown by all sectors across the board. On the other hand, it also reveals that the support provided by the foreign sector steadily faded from mid-2023 onwards and there are few signs of improvement in the latest data.

Sector traffic light for the Spanish economy
(% of the total number of sectors)



Notes: *The traffic light chart indicates the percentage of sectors that fall within each of the 5 growth categories, which are defined as follows: «significant weakness» if the value taken by the sector indicator lies below the 15th percentile (P15) of that indicator's historical distribution; a position of «weakness» when it takes a value between P15 and P40; «stability» between P40 and P60; «expansion» between P60 and P85, and «significant expansion» when the indicator lies above P85.*
Source: *BPI Research, based on data from the Spanish National Statistics Institute (INE), the Spanish Tax Agency (AEAT), the Ministry of Inclusion, Social Security and Migration (MISSM), DataComex and the Spanish national grid (REE).*

Where in the cycle does each sector lie?

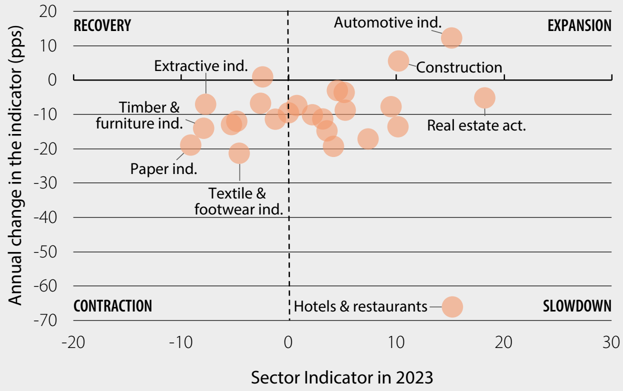
Taking a closer look at the various economic sectors, the CaixaBank Research Sector Clock allows us to visualise where in the cycle each sector lies at any given time. Specifically, the Sector Clock shows the indicator's level on the horizontal axis and its change in the last year on the vertical axis. In this way, the resulting quadrants offer a picture of the sector's current position and its recent

1. For further details of the methodology used to build this indicator, see the methodology box in the Sector Observatory 2024 (https://www.caixabankresearch.com/es/analisis-sectorial/observatorio-sectorial/indicador-sectorial-caixabank-research).

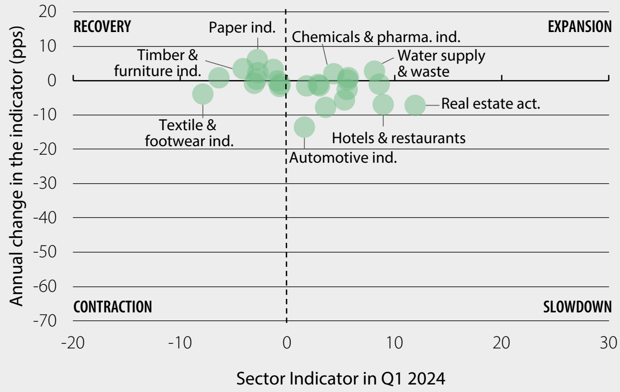
2. The sector traffic light is a chart in which the various economic sectors are classified into five categories according to their rate of growth. In particular, a sector is considered to be in a position of significant weakness if the value taken by the sector indicator lies below the 15th percentile (P15) of that indicator's historical distribution; a position of weakness when it takes a value between P15 and P40; stability between P40 and P60; expansion between P60 and P85, and significant expansion when the indicator lies above P85.

CaixaBank Research Sector Clock

2023



Q1 2024



Source: *BPI Research, based on data from the Spanish National Statistics Institute (INE), the Spanish Tax Agency (AEAT), the Ministry of Inclusion, Social Security and Migration (MISSM), DataComex and the Spanish national grid (REE).*

trend: expansion (indicator in positive territory and with growth in the last year); slowdown (positive indicator, but with a decrease in the last year); contraction (negative indicator and in decline in the last year); and recovery (negative indicator, but growing in the last year). Comparing the Clock for 2023 with that of the opening months of 2024, we can see where the sectors currently lie in the cycle, as well as their recent trend:

- In the opening months of 2024, the sectors are grouped near the centre of the clock, which indicates less dispersion between them.
- The chemicals and pharmaceutical industry, water supply, retail, and professional and administrative activities show an improvement and have moved into the expansion quadrant.
- Many industries have also improved, having moved into the recovery quadrant after several years weighed down by the rise in costs (the timber, paper, extractive, refining and construction auxiliary industries).
- Real estate activities, transport equipment manufacturing and the hotels and restaurants sector have moved into the slowdown quadrant, although they remain among the best performing sectors.
- The agrifood sector and the textile and footwear industry remain in the contraction quadrant and are joined by wholesale trade.

Outlook for the Spanish economy and its sectors: what we expect in 2024 and 2025

The outlook for the Spanish economy for 2024-2025 is positive, although a slight moderation is anticipated in GDP growth. Specifically, it is expected to fall from 2.5% in 2023 to 2.4% in 2024, before consolidating at a rate of 2.3% in 2025, according to CaixaBank Research's latest forecasts. In this scenario, we expect that the dispersion of growth rates between sectors will continue to

Sector forecasts for 2024-2025

Above-average expansion:
- Information & communications (ICT)
- Pharmaceutical industry
- Tourism
- Construction

→ They share very positive secular trends or a significant international competitive advantage

Near-average growth:
- Agrifood sector
- Automotive industry
- Real estate activities
- Trade

→ With the normalisation following the recent shocks, they will show a more stable pattern of behaviour

Moderate weakness:
- Textile industry
- Paper industry

→ They share weaker secular trends, due to cost pressures and greater exposure to international competition

gradually reduce, as the impact of the rise in production costs and the interest rate hikes is gradually diluted. In fact, we do not expect GVA to contract in any of the sectors analysed, and the different growth rates will be largely determined by the medium and long-term trends.

Some of the sectors in which we expect to see the highest growth rates in 2024-2025 include those linked to the digital transition (such as information and communication technologies, and professional services) and sectors in which Spain is highly competitive (such as the pharmaceutical or tourism sectors). At the other extreme, the textile and paper industries are the sectors we expect to show more moderate growth.

Activity and employment indicators

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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Industry									
Industrial production index	2.2	–1.2	–2.2	–2.2	–0.7	0.0	–1.3	0.8	...
Indicator of confidence in industry *(value)*	–0.8	–6.5	–5.2	–8.2	–8.1	–5.2	–5.7	–4.3	–6.3
Manufacturing PMI *(value)*	51.0	48.0	48.5	47.3	45.9	50.7	51.4	52.2	54.0
Construction									
Building permits *(cumulative over 12 months)*	15.4	1.2	1.7	4.3	0.6	–0.7	–2.9	...	...
House sales *(cumulative over 12 months)*	29.0	0.3	3.2	–3.2	–9.0	–10.2	–10.7	...	...
House prices	7.4	4.0	3.6	4.5	4.2	6.3	...	...	...
Services									
Foreign tourists *(cumulative over 12 months)*	129.8	18.9	40.7	21.9	18.9	15.8	15.8	14.9	...
Services PMI *(value)*	52.5	53.6	56.0	50.9	51.2	54.3	56.1	56.2	56.9
Consumption									
Retail sales[1]	2.3	2.5	2.4	2.1	2.9	1.1	0.9	0.3	...
Car registrations	–3.0	18.5	9.9	6.9	11.9	4.2	–4.7	23.1	3.4
Consumer confidence index *(value)*	–26.5	–19.2	–19.1	–16.1	–19.1	–17.2	–15.8	–14.7	–14.5
Labour market									
Employment[2]	3.6	3.1	3.2	3.4	3.6	3.0	–	–	–
Unemployment rate (% labour force)	13.0	12.2	11.7	11.9	11.8	12.3	–	–	–
Registered as employed with Social Security[3]	3.9	2.7	2.8	2.7	2.6	2.6	2.6	2.4	2.4
GDP	**5.8**	**2.5**	**2.0**	**1.9**	**2.1**	**2.4**	–	–	–

Prices

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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
General	8.4	3.6	3.1	2.8	3.3	3.1	3.2	3.3	3.6
Core	5.1	6.1	6.2	6.0	4.5	3.5	3.3	2.9	3.0

Foreign sector

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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	22.9	–1.4	12.3	4.5	–1.4	–6.9	–6.9	...	...
Imports *(year-on-year change, cumulative over 12 months)*	33.4	–7.2	10.7	–1.2	–7.2	–9.8	–9.8	...	...
Current balance	**8.2**	**38.0**	**28.7**	**35.8**	**38.0**	**37.9**	**37.9**	**...**	**...**
Goods and services	16.3	60.3	42.6	54.6	60.3	61.0	61.0	...	...
Primary and secondary income	–8.1	–22.3	–14.0	–18.8	–22.3	–23.1	–23.1	...	...
Net lending (+) / borrowing (–) capacity	**20.7**	**53.9**	**42.6**	**50.0**	**53.9**	**52.5**	**52.5**	**...**	**...**

Credit and deposits in non-financial sectors[4]

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

	2022	2023	Q2 2023	Q3 2023	Q4 2023	Q1 2024	03/24	04/24	05/24
Deposits									
Household and company deposits	4.9	0.6	0.4	–0.3	0.4	2.5	3.5	2.4	...
Sight and savings	7.9	–4.5	–4.0	–6.9	–7.6	–6.6	–5.2	–5.7	...
Term and notice	–19.7	51.9	40.1	69.5	90.4	104.3	96.5	86.8	...
General government deposits	9.6	8.7	6.8	11.3	9.4	27.2	43.6	62.6	...
TOTAL	**5.2**	**1.1**	**0.8**	**0.5**	**1.0**	**4.1**	**6.3**	**6.6**	**...**
Outstanding balance of credit									
Private sector	0.7	–2.5	–2.2	–3.4	–3.7	–2.9	–2.6	–2.4	...
Non-financial firms	0.9	–3.4	–2.7	–4.6	–5.2	–4.0	–3.6	–3.2	...
Households - housing	1.0	–2.6	–2.4	–3.4	–3.3	–2.8	–2.5	–2.4	...
Households - other purposes	–0.6	–0.2	–0.4	0.0	–0.5	–0.3	–0.1	–0.1	...
General government	0.2	–3.4	–3.3	–4.6	–5.5	–2.9	–4.8	–3.6	...
TOTAL	**0.7**	**–2.6**	**–2.3**	**–3.4**	**–3.8**	**–2.9**	**–2.7**	**–2.4**	**...**
NPL ratio (%)[5]	**3.5**	**3.5**	**3.5**	**3.5**	**3.6**	**3.6**	**3.6**	**3.6**	**...**

Notes: *1. Deflated, excluding service stations. 2. Active Population Survey. 3. Average monthly figures. 4. Aggregate figures for the Spanish banking sector and residents in Spain. 5. Period-end figure.*
Sources: *CaixaBank Research, based on data from the Ministry of Economy, the Ministry of Transport, Mobility and Urban Agenda (MITMA), the Ministry of Inclusion, Social Security and Migration (MISSM), the National Statistics Institute (INE), S&P Global PMI, the European Commission, the Department of Customs and Excise Duties and the Bank of Spain.*

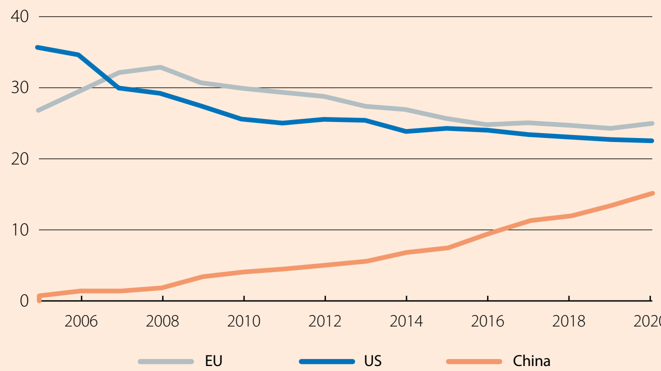
Europe's moment: it is time to bolster our competitiveness

The years of European elections that mark the renewal of the main EU institutions are the ideal time to reflect on the strengths and weaknesses of the single market at an economic level and the challenges that lie ahead. This is the topic of this Dossier of the *Monthly Report*. In particular, one of the hottest topics in the public policy debate is that of competitiveness, in a very specific context marked by the restructuring of global value chains, the rise of China and the acceleration of the energy and digital transitions. In other words, we talk about the extent to which the European economy is capable of producing attractive goods and services, while maintaining and improving the well-being of its citizens in the long term. The determining factors include a set of institutions, policies and other elements that are interrelated and they include concepts such as human capital, the degree of innovation incorporated into the products and services that are produced by its companies, the efficiency of the productive and organisational processes of these companies, and many others. In which of them is the EU doing well and in which ones is it failing?

In order to organise ideas and narrow down the debate, the European Commission has published a revealing analysis that sheds some light on this complex issue.[1] It identifies the nine major pillars that determine Europe's competitiveness and analyses the European economy's position in each of them.

This analysis reveals that the EU is making good progress and is in a relatively comfortable position in the following three dimensions: reducing regulatory barriers that hinder the functioning of the single market, energy and international trade. The EU is doing particularly well in the case of energy thanks to the growth of renewable energies, which now account for 23% of energy generation in the EU, with the goal to reach 45% by 2030. If we look at the proportion that the EU represents in the total number of patents registered worldwide related to green technologies (see first chart), we can see that we remain in the lead, despite our relative weight in the total dwindling in recent years due to the emergence of China. Europe's leadership is based on innovation in wind energy, where the EU held 62% of all patents in 2020, by which time China had already caught up with the EU-27 in patents related to solar energy. Despite the relatively positive assessment in the energy sphere, we cannot rest on our laurels: in a world in constant transformation, the EU faces the Herculean challenge of electrifying its energy demand, and this will require significant investments and the need to redesign the European electricity market in order to connect new clean energy production centres with consumption centres. In terms of international trade, the report highlights that the EU is the largest global exporter (accounting for 16% of all countries' imports, slightly above China and well above the US) and that it is especially strong in the sphere of high-tech products and services.

Share of total global patents related to green transition
(%)



Source: *European Commission, «European Monitor of Industrial Ecosystems 2023».*

Before moving on to the four areas where improvement is needed, it should be mentioned that there are two pillars with a more neutral assessment, where the European economy is showing signs of improvement, and which pose a major challenge. Specifically, these are public investment and the circular economy. In public investment, the starting point is that the Next Generation programme is making a positive contribution in terms of mobilising investment and that the level of public investment in the EU (3.3% of GDP) is similar to that in the US. Looking ahead, if the digital and energy transitions are to be successful, it is essential that private investment be supported by public investment, to guarantee both the quantity and the quality of the investor mix. This will help ensure that the digitalisation and decarbonisation processes give rise to more vibrant European economic sectors. In this regard, the EU's role in coordinating and accelerating large cross-border investments and ensuring that productive sectors are transformed without losing competitiveness will be essential. With regards to the circular economy, steady progress is being made towards a more efficient and sustainable use of commodities and we are halfway towards the targets set for 2030.

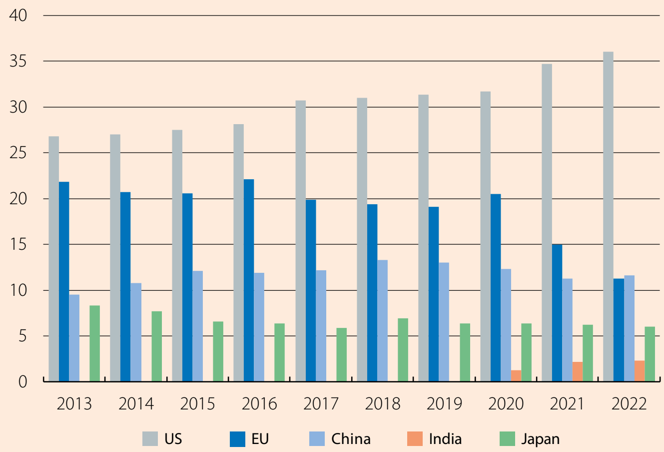
Finally, the four dimensions with the greatest room for improvement are digitalisation, access to private capital, research and innovation and human capital. With regards to digitalisation, there is one particularly revealing piece of data: the EU's global share of the information and communications technology (ICT) market fell from 21.8% in 2013 to 11.3% in 2022 (see second chart), while in the US it rose from 26.8% to 36.0% in the same period. If we look at the EU's global weight in digital patents, it fell by 4 pps between 2015 and 2020 to 21% of the total, a decline similar to that of the US. In technologies related to manufacturing and the Internet of Things, the report notes the EU has maintained its strength, but it has lost its edge in the robotics industry to China. Finally, the use of artificial intelligence (AI), a new technology with enormous disruptive potential as explained in the following

1. See «The 2024 Annual Single Market and Competitiveness Report» published by the European Commission in February 2024.

article in this Dossier,[2] is still low: it is used by 9% of European SMEs and 30% of large corporations.[3] In order to redress the situation in the digital sphere, in his report on the single market, Enrico Letta[4] proposes establishing a single market for telecommunications that allows pan-European operators to flourish, as well as a common regulatory framework in order to provide a boost to technologies such as 5G and reduce Europe's dependence on digital services from outside countries.

Market shares in ICT technologies

(% of the total)

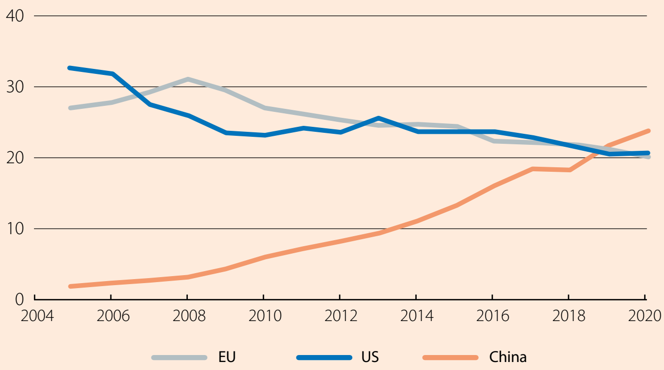


Source: *Information and Communication Technology Statistics and Facts (market.us).*

As for access to private capital,[5] this is an Achilles heel of the EU market and a shortcoming that we cannot afford to live with if private investment is to pick up. In this regard, the Commission emphasises that the size and highly disaggregated nature of the EU's capital markets is clearly inadequate to support growth in the medium term. In fact, the capitalisation of the EU stock market, as a percentage of GDP, is less than half that of the US, despite the higher level of savings in Europe. Venture capital, which allows innovative companies with limited access to external financing to thrive, is 0.09% of GDP, paling compared to the US (0.75%) or China (0.58%). In his report on the single market, Enrico Letta has also raised the alarm about the lack of a capital market in Europe and has put forward bold proposals to address this. The proposals include launching a long-term savings financial product at the European level in order to stimulate retail investments and creating a European risk-free asset with a view to ensuring the stability and uniformity of the EU's financial market.

Share of total global patents related to digital technologies

(%)



Source: *European Commission, «European Monitor of Industrial Ecosystems 2023».*

Finally, it is worth making two brief comments on innovation and human capital. The total investment (public and private) in innovation in the EU is 2.2% of GDP; this is well below that of the US (3.4%) and varies significantly from region to region, making it difficult to extend it throughout the continent. Here the EU can promote policies and tools to enhance synergies between business sectors and academic institutions, thus facilitating a better diffusion of innovation while also supporting start-ups and scale-ups.[6]

In terms of human capital, the widespread setback of European countries in the education sphere, according to the PISA report, has caused cold sweats that are fully justified. We are at a delicate juncture, as we do not know how educational needs will evolve in the face of accelerated and continuous changes in technology. Continuous learning is key, but currently only 1 in 3 adults in the EU participates in training activities each year. The difficulties in attracting qualified staff who are fully trained in digital and green skills (so-called white blackbirds) will be the order of the day, but the low level of labour mobility in Europe does not help.[7]

In short, the EU faces a triple challenge: (i) how to successfully incorporate new technologies, with a special mention of AI, to increase its potential growth while mitigating labour market disruptions to prevent the rise of Neo-Luddism; (ii) how to boost investment and improve productivity in a context of marked variations between countries and high investment needs,[8] and (iii) how to achieve a true integration of its capital markets in order to finance these investments. These are precisely the topics covered in depth in the following three articles of this Dossier. Read on!

2. See the article «Artificial intelligence: challenges and opportunities for Europe» in this same Dossier for an in-depth analysis.
3. Data from the European Commission's Digital Decade Report (2023) with data from 2022. These adoption rates appear to be slightly higher than those in the US. According to the National Science Foundation, in 2022 25% of large corporations and 4% of SMEs in the US had adopted AI.
4. See E. Letta (2024), «Much more than a market: Empowering the Single Market to deliver a sustainable future and prosperity for all EU Citizens», European Commission.
5. See the article «Why does Europe need a Capital Markets Union?» in this same Dossier for an in-depth analysis.
6. Companies that have grown for three consecutive years at a rate of over 20% in turnover and number of jobs.
7. Only 3.8% of workers born in the EU work in a European economy other than the one in which they were born and only 17% of EU citizens have lived or worked at some point in their lives in a country other than their own.
8. See the article «Productivity growth in Europe: low, uneven and slowing» in this same Dossier.

Artificial intelligence: challenges and opportunities for Europe

What is generative artificial intelligence and why is it important for productivity?

Generative artificial intelligence (AI) is one of the most disruptive and promising technologies of our time. Its ability to create, imitate and improve content of all kinds makes it a general purpose technology (GPT) with a potential for economic and social transformation comparable to that of electricity or computer science. Its potential impact and how to use it in the best possible way – a major challenge for Europe and for the whole world – is what we will discuss in this article.

The transformative capacity of a GPT derives from its multi-purpose nature and its impact on a wide range of tasks in many different sectors and activities, as well as its potential for continuous growth and to facilitate the development of other technologies and processes. AI, moreover, has the peculiarity of being a very accessible and adaptable GPT, since using it does not require a great deal of knowledge and the infrastructure that it requires already exists (at least in developed countries). Thus, while in pre-ChatGPT Europe only 10% of companies used AI, it is expected that this percentage will increase dramatically in the coming years (the goal is to reach 75% by 2030, according to the European Digital Strategy). This implies that AI's impact on productivity could materialise within a much shorter time frame than what has been experienced on previous occasions, that is, in the space of years rather than decades.

What do we know right now about the impact of AI? The first empirical studies available have a microeconomic spectrum and refer to specific occupations, but they already show that AI has a very high potential to increase worker productivity. For example, in a controlled experiment, it is found that the time spent performing a task that involves writing a text decreases by about 40% in workers who used ChatGPT.[1] It has also been estimated that the productivity of a contact centre, measured by the number of problems resolved per hour, increased by 14% thanks to the impact of AI on less experienced workers, although the impact was not significant in the case of more experienced workers.[2] One conclusion that emerges from these studies, therefore, is that productivity improvements are greater for workers who start with a lower level of productivity, because AI enhances their skills and allows them to traverse the learning curve more quickly.

AI and the labour market: impact, past experiences and institutional framework

Beyond these initial results, the impact of AI on the labour market is still uncertain. On the one hand, we must take account of the effect on existing occupations, which will depend in each case on: (i) the degree of overlap between the capabilities of AI applications and the tasks performed by the worker, and (ii) the degree of protection of the workplace (due to technical, legal, or ethical reasons, etc.). Thus, we can distinguish between three types of occupations:

1. High exposure, high protection. The technical potential of AI is high, but so is the degree of protection of the workplace. In these cases, AI will tend to enhance workers' skills. Example: judges, doctors, etc.

2. High exposure, low protection. High technical potential of AI and low level of protection. In these cases, although AI could enhance workers' skills, it could also replace them. Example: telephone operators.

3. Low exposure, low technical potential of AI. These occupations would not be widely affected by AI. Example: artists and show workers.

According to an IMF study,[3] in advanced economies, which naturally include those of Europe, the first two categories account for 60% of current employment, spread approximately equally between them. This percentage is lower in emerging economies, where the figure is less than 40%. Due to the multi-purpose nature of AI, it is estimated that the potentially substitutable occupations are both skilled and unskilled in nature and that workers at all income levels will be affected. In contrast, occupations with low substitutability tend to be concentrated at high income levels.

In any case, it is difficult to anticipate precisely what the effect on employment may be in a given occupation. In occupations with high exposure to AI and high protection, increasing the productivity of these workers would decrease the number of employees

1. See S. Noy and W. Zhang, 2023. «Experimental evidence on the productivity effects of generative artificial intelligence», SSRN 4375283.
2. See E. Brynjolfsson, Danielle Li and Lindsey R. Raymond, 2023, «Generative AI at work», NBER Working Paper 31161.
3. See IMF, 2024, «Gen-AI: Artificial Intelligence and the Future of Work».

required for a certain level of production. However, if the demand for the goods or services produced by these types of workers increases sufficiently, then the number of people employed in these categories may increase (demand should rise, because the cost of these goods and services would fall thanks to the increase in productivity). For instance, will the number of surgeons increase if they become more productive with AI? It would not be necessary to perform the same number of interventions, but it would no doubt increase the demand for interventions (some that are currently on a waiting list, due to unsatisfied demand because they are currently too expensive, such as cosmetic surgeries; others because advances in AI will allow more pathologies to become «operable», etc.). Depending on which effect prevails, there will be either a decrease or an increase in the number of surgeons.

The same effects, albeit with varying intensity, are at play in high-exposure and low-protection occupations. Will the number of employees working in contact centres decline? Although in theory we could assume so, if much of this work can be done by AI, some companies may also choose to hire more people to carry out these tasks, since they can be much more productive with the help of AI. After all, it will depend on whether the company uses AI basically to replace what a human has been doing or whether it uses it to expand and improve the service. In this latter case, it could even lead to an increase in the number of workers offering customer service remotely.

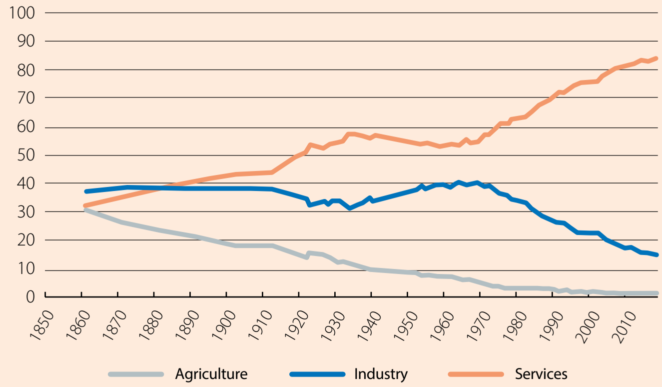
In addition, we must take into account new occupations that will arise as a result of AI, such as that of prompt engineer, algorithm auditor, experts in AI-related legal regulation or ethics, etc.

Ultimately, the aggregate impact of AI will depend on (i) the balance between jobs that are supplemented by AI versus those that are replaced; (ii) the aggregate productivity gains, which will drive income levels and, with it, a general increase in demand for goods and services which will require workers, and (iii) the new occupations that arise as a result of AI, either directly or due to the emergence of new products, services or business models.

Although this time may be different, the impact that disruptive technological changes have had on the labour market in the past, such as the Industrial Revolution in the 19th century or the introduction of computers 40 years ago, can offer some clues. Notably, despite the rapid technological change of the last 150 years, the employment rate has not changed significantly in developed economies. Generally speaking, employment has shifted from more automated sectors to new sectors created by technology and those that are less automated. In the Industrial Revolution, for example, a lot of employment was destroyed in agriculture, but a great deal was created in industry, as the chart shows. One of the most powerful lessons we can learn from processes of technological change is that the dissemination throughout society of the opportunities generated by technical progress depends on the institutions. If they are flexible and dynamic, they will facilitate the emergence of new sectors and occupations that take full advantage of the new technology and cushion the negative effects on the most exposed occupations.

Proportion of workers by sector: United Kingdom

(%)



Source: *J. Pijoan-Mas (2017). «Cambio tecnológico y el futuro del empleo».*

The challenges for economic policy and institutions in general are vast, covering areas ranging from education (what kind of training do we need to prepare for the AI era?) to competition and innovation (AI offers opportunities for innovation, but it carries risks, such as market concentration) and even inequality (how can we protect those segments of the population that suffer the negative effects of AI on wages and employment?). There is no doubt that European public policies must, at the very least, promote the adaptation of the education system to AI; manage the costs derived from the possible destruction of jobs, through active employment policies; ensure European «strategic autonomy» in infrastructures that support the development of AI, and develop a regulatory framework that provides legal certainty in this area.

Productivity growth in Europe: low, uneven and slowing

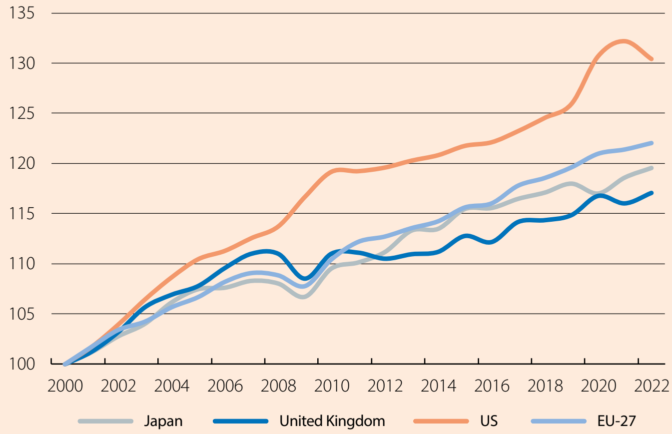
Increasing productivity growth is one of the major challenges that Europe faces. As stated in the introductory article of this Dossier, «Europe's moment: it is time to bolster our competitiveness», it is urgent to update the productive fabric of Europe's economy. Rapid technological change allows this. Moreover, the global context, which is increasingly competitive and with a growing distrust of multilateral institutions, makes it imperative.

Productivity has grown steadily in the EU over the past two decades. The average annual growth of GDP per hour worked[1] between the year 2000 and 2022 was 1.2%, and negative growth rates were only observed in 2008 and 2009, in the midst of the global financial crisis. Thus, in 2022 productivity was 26.6% higher than in the year 2000.

However, it should be noted that the rate at which productivity is growing has slowed in recent years. Across the EU as a whole, productivity grew by an average of 1.9% per year between 2000 and 2006. In contrast, since the financial crisis, the pace of growth has slowed significantly. Between 2007 and 2022, average annual growth stood at 0.9%. Declining productivity growth is a pervasive phenomenon in the major developed economies. In the US, productivity has gone from growing by 2.4% to 1.3%; in the UK, from 1.8% to 0.4%; and in Japan, from 1.5% to 0.8%.

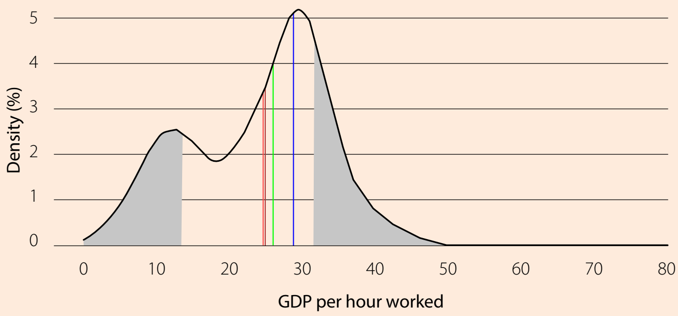
Evolution of productivity

Index (100 = 2000)

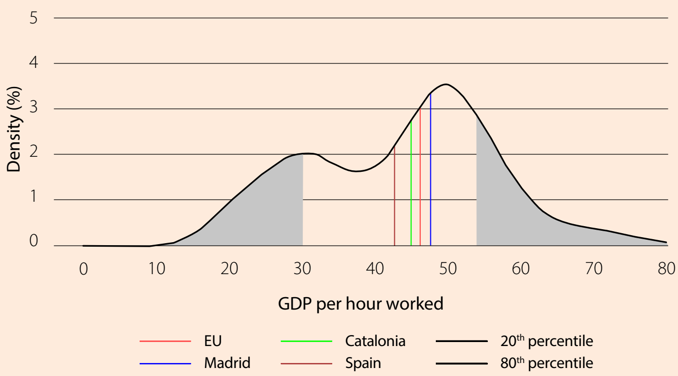


Note: *GDP in real terms per hour worked.*
Source: *BPI Research, based on data from the OECD.*

Distribution of productivity in the various European regions in the year 2000



Distribution of productivity in the various European regions in the year 2000



Notes: *The chart shows the probability of observing a region (on the vertical axis) with a certain level of productivity (horizontal axis). For example, the probability of observing a region with a productivity of 20 was 2% in the year 2000. A continuous distribution of probability has been estimated. GDP measured in PPP terms per hour worked. Data for all NUTS 2 regions of the EU, except Ireland, Luxembourg, Malta, Cyprus, Croatia, the French overseas regions, the Azores, Madeira, Ceuta and Melilla.*
Source: *BPI Research, based on data from the Annual Regional Database of the European Commission (ARDECO).*

These figures also reveal another element: productivity growth in the EU has been lower than in the US economy over the last few decades. The difference may seem small: it is just 0.4 pps lower between the years 2000 and 2022, on average. However, as the difference in growth persists for many years, the implications end up being significant: the gap between the productivity of the European economy and that of the US has widened by 8.4% since the year 2000.

Analyzing the state of productivity in the various European regions helps us understand the figures for the EU as a whole. As shown in the second chart, the distribution of productivity is concentrated at two different points. There is a first group of regions with a relatively low level of productivity, and a second group of regions with a higher level. The peak of the first group lies around the first quintile of the distribution, which in the year 2000 is at a level of GDP per hour worked of 13.6 euros. The peak of the second group corresponds, also closely, to the 80th percentile of the distribution, with a GDP per hour worked of 31.4 euros. In between these two groups is where all Spanish regions lie.[2]

In recent decades, the growth in regions with lower productivity levels has not been strong enough to narrow the gap between them in absolute terms; in fact, it is quite the contrary. The gap between the first group of regions (the least productive) and the group formed by the most productive

1. To calculate the rate of productivity growth, GDP is used at constant prices of 2015 per hour worked in order to eliminate the effect of inflation and obtain a measure of productivity growth in real terms.
2. For a more detailed analysis, see «Evolución de la productividad en Europa: una mirada regional», at www.cercledeconomia.com.

regions has actually widened over the last two decades. Specifically, the first quintile increased to 30.1 euros in 2022 and the 80th percentile stood at 53.8. Thus, the distance between the two mountains has widened by 5.9 euros, or 33 4%.[3]

The belt of regions that begins in Denmark, the Netherlands and Belgium, and runs down through Germany to Austria, is the one that has strengthened the most in recent years (see third chart). This group of countries accounts for 82% of the regions that were in the highest productivity range in 2022, while in 2000 this figure stood at 75%. Seen differently, 48% of the regions in these countries were in the top 20 most productive regions in 2022, while in 2000 this was the case for «only» 43% of them.

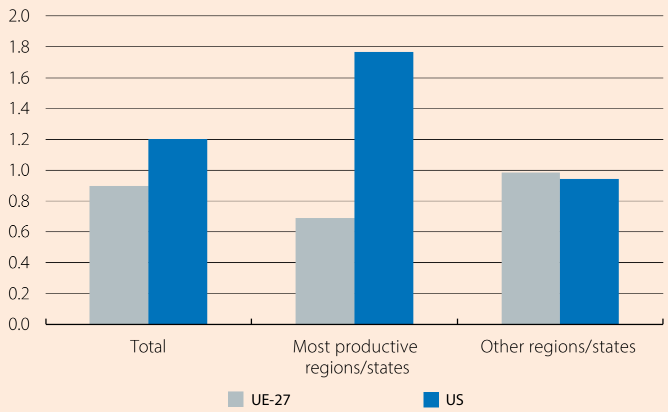
In contrast, many of the French and Italian regions have lost dynamism in recent years. Italy had five regions in the highest productivity group in the year 2000, whereas by 2022 it had only one, namely the autonomous province of Bolzano, and the country's southern regions have moved to a low level of productivity. France has only two regions left with a very high level of productivity, and the number of regions in the high productivity range has declined.

However, productivity growth in the most productive European regions has been modest compared to the improvement experienced by the most productive US states.[4] As can be seen in the fourth chart, the difference is significant: between 2007 and 2022, on average, growth was 1.1 pp higher. In contrast, US productivity growth without these regions is quite similar to that of the rest of the European regions.

As for the Spanish regions, in 2000 the majority (58.82%, specifically) were in the middle section of the distribution (in the third quintile of the productivity distribution), while Madrid had high productivity and the remaining regions of the country had

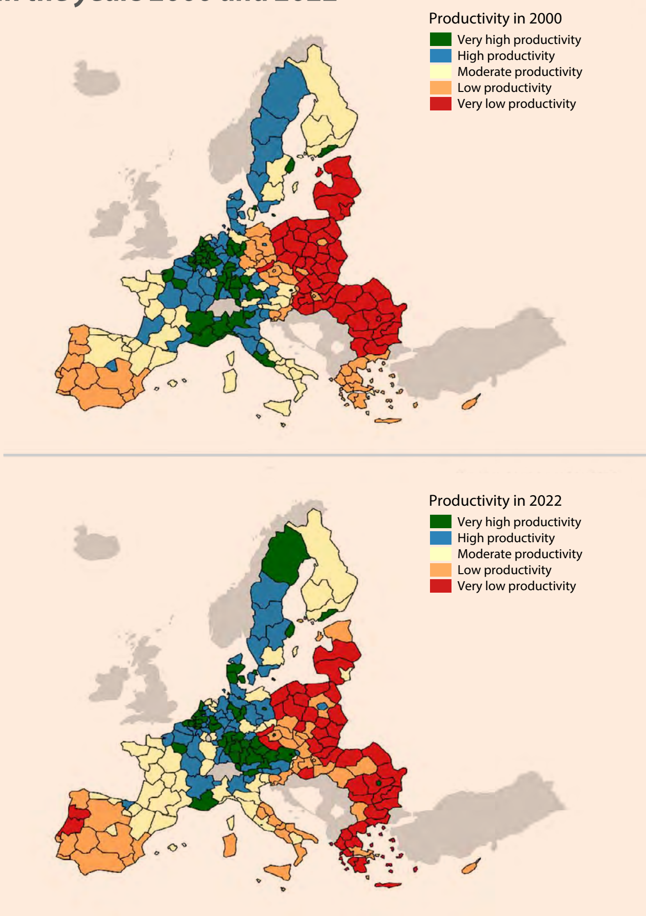
Productivity in the EU-27 and the US

Average annual growth between 2007 and 2022 (%)



Notes: *Productivity refers to GDP in real terms per hour worked. The productivity growth of the most productive European regions and US states relates to the quintile of most productive regions/states.*
Source: *BPI Research, based on data from the European Commission (ARDECO) and the US Bureau of Labor Statistics.*

Distribution of productivity by region in the years 2000 and 2022



Note: *GDP measured in PPP terms per hour worked. The classification of the level of productivity is produced based on quintiles, dividing the distribution of productivity into five equally sized groups, with each one comprising 20% of the total sample of regions in ascending order. Thus, the first group contains the 20% of regions with the lowest level of productivity, the next group contains the 20% of regions with a higher productivity than the previous group, and so on until the European regions are separated into five groups of equal size, where each group denotes a «step» in the distribution of productivity.*
Source: *BPI Research, based on data from the European Commission (ARDECO).*

low productivity. In general, the regions of the northern half are in the moderate productivity group, while those of the southern half are in the low productivity group. Between 2000 and 2022, there are three regions that dropped down to the low productivity level, such that most regions, specifically 52.9%, fall into this group in 2022. The Community of Madrid ends up in the moderate productivity group and the Basque Country is the only region to climb up a level, becoming part of the high productivity group.

In the lower part of the distribution, of particular note is the collapse of the regions of Greece, which now find themselves at the tail end of the distribution of European productivity. Indeed, 78.6% of the regions falling from quintile 2 to 1 are Greek. In contrast, all the regions that climb from quintile 1 to 2 correspond to different countries in Eastern Europe.

3. The distance between the 80th percentile and the 20th percentile widened between 2000 and 2022, regardless of whether the evolution of the distribution of GDP per hour worked is analysed in real terms or adjusted for PPP.
4. The most productive quintile of US states, which includes California, New York and Massachusetts, accounts for 31% of US GDP. The quintile of the most productive European regions accounts for 29% of Europe's GDP.

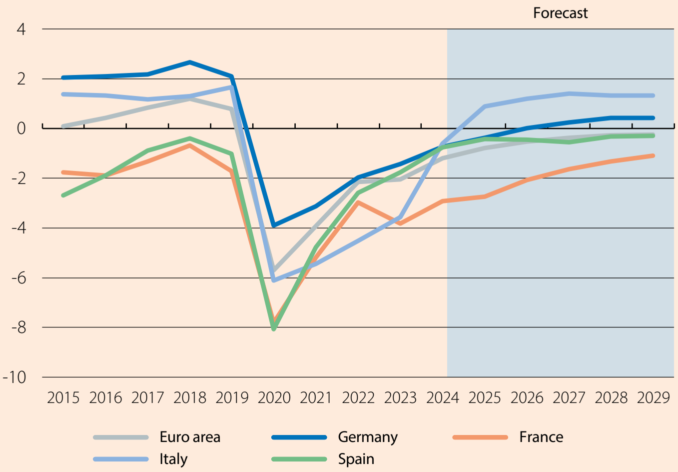
Why does Europe need a Capital Markets Union?

Europe is facing not only a demanding economic situation, but also a trident of underlying challenges: the decarbonisation of the economy, the revitalisation of productivity and technological development, and the growing geopolitical fragmentation in the world. Addressing these challenges will not be possible without mobilising significant investment and financing, on the one hand, or without strengthening the international role of the euro, on the other. And this is precisely what the Capital Markets Union (CMU) is pursuing.

Is Europe falling behind?

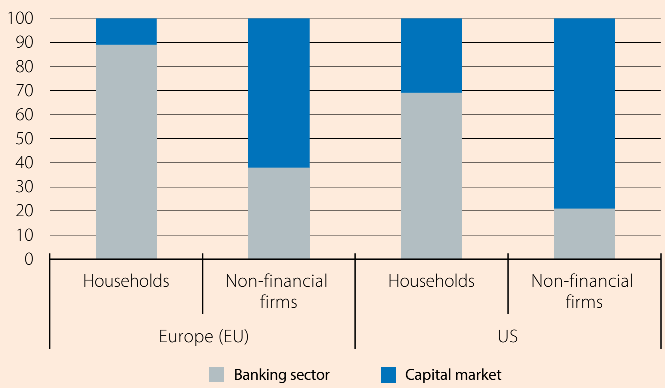
In order to tackle these underlying challenges, several estimates suggest that Europe will need to deploy between 0.5 and 1 trillion euros per year through to 2030.[1] These additional investment needs, which are equivalent to the annual GDP of countries such as Austria or the Netherlands, arise in a context in which fiscal policy has less margin for manoeuvre, being weighed down by high public debt ratios, with underlying pressures on public spending (e.g. population ageing) and with the need for and the prospect of a gradual correction of budget deficits (see first chart). On the other hand, there is a large stock of private savings which is not mobilised and, for Europe's purposes, it is vitally important to develop a strong common capital market,[2] that is, a market in which savings and investment flow between all EU countries through bonds, shares and other financial assets.

Euro area: primary fiscal balance
(% of GDP)



Source: *BPI Research, based on data and forecasts from the IMF (WEO of April 2024).*

Sources of financing for households and businesses in 2022
(%)



Source: *DG Trésor (2024), «Developing European capital markets to finance the future: Proposals for a Savings and Investments Union», Ministère de l'Économie, des Finances et de la Souveraineté industrielle et numérique.*

However, there is consensus that the European capital market is underdeveloped (see second chart). This can be seen in a long list of cases which, if read in positive terms, indicate the potential to mobilise funds that an effective capital markets union would allow to materialise. As an example, while the EU accounts for around 20% of the world's GDP, its stock markets represent just 10% of global capitalisation, and within the technology sector there are just two European companies in the top 20 in terms of capitalisation. Moreover, the liquidity of Europe's stock markets is lower than that of other regions (the US), especially in the case of so-called small-cap companies (which are younger and have greater growth potential). The emergence of tech firms also requires a developed venture capital market,[3] which is currently too small in Europe (the size of Europe's venture capital markets is only 20% of that of the US) and is also fragmented (portfolios have a significant

1. M. Demertzis, D. Pinkus and N. Ruer (2024), «Accelerating strategic investment in the European Union beyond 2026», Report 01/2024, Bruegel, and DG Trésor (2024), «Developing European capital markets to finance the future: Proposals for a Savings and Investment Union», Ministère de l'Économie, des Finances et de la Souveraineté industrielle et numérique. These figures include investments to decarbonise all economic sectors, transform the energy industry, address various environmental challenges, develop key digital technologies (communications, AI, semiconductors, etc.) and strengthen supply chains related to the defence industry.
2. Enrico Letta talks about more than 30 trillion euros, largely stored in cash and deposits. Moreover, he estimates that around 300 billion euros of European households' savings leave Europe each year (primarily destined for the US). E. Letta (2024), «Much More Than a Market», Report to the European Council.
3. Innovation produces projects that are high-risk, offer uncertain returns and have few tangible assets to back them up. The venture capital industry has specialised in financing innovation, detecting and supporting the birth of tech firms with a high potential thanks to its governance system, with phased financing and active participation in the companies in question. See J. Lerner and R. Nanda (2020). «Venture capital's role in financing innovation: What we know and how much we still need to learn», Journal of Economic Perspectives, 34(3), 237-261.

national bias). European public and private bond markets are also relatively small (130% of GDP in the EU vs. 200% in the US). All this affects the cost of financing European companies, as well as their ability to expand, to the point that some start-ups born in Europe have ended up migrating to the US in search of funds.[4] Similarly, Europe's financial sector has been gradually losing market share with respect to its US counterparts, both in terms of asset management and in investment and corporate banking.[5]

Background, current situation and outlook for the CMU

The CMU project was born a decade ago in the face of a combination of considerations, ranging from financial stability (e.g. reducing the fragmentation of European markets, increasing the capacity to absorb economic shocks and diversifying sources of business financing), to social justice (ensuring that all EU citizens have equal access to capital markets), to economic efficiency and ensuring the availability of financing for innovation and investment. However, as we have already seen, this initial ambition has not resulted in a significant development of the European capital market, nor has it led to an effective transformation of policies.

In fact, in 10 years the progress has been more incremental, rather than one of structural transformation.[6] This is illustrated by the nature of the key milestones achieved to date, which include the so-called «single access point» (a facility that centralises and gives access to publicly available financial information on European companies and investment products, the legislative framework of which was formalised in December in 2023 but which will still take some years to be developed), the «European Long-Term Investment Fund» (ELTIF, which is a vehicle for channelling private capital towards investment in infrastructure and other long-term projects and enterprises, which the EU has tried to stimulate but without managing to raise significant amounts of capital so far) and a revision of the trading rules to improve transparency in financial instruments markets (MiFIR regulation and MiFID directive).

In the run-up to the European elections in June, which mark the beginning of a new term for 2024-2029, a number of voices have pushed for a reignition of the CMU project. In March, both the Eurogroup and the ECB launched manifestos to develop the CMU with an agenda of concrete measures related to developing markets (e.g. asset securitisation), supervision and regulation (advocating a direct role of European supervisory agencies and reducing the regulatory burden) and European harmonisation of national regulations and frameworks (in areas such as insolvency, accounting, debt issuance, collateral management, securities markets, etc.), among other initiatives.

The CMU joins a list of European economic integration projects that remain incomplete. These include the Banking Union, as negotiations on the European Deposit Insurance Scheme (EDIS) remain at an impasse,[7] and the ESM reform, which was agreed in 2021 but is not yet effective.[8] The difficulty of all these initiatives is that, when the integration being pursued is ambitious (whether a European deposit guarantee scheme or harmonising insolvency and accounting frameworks), it is necessary to overcome a clash between national jurisdictions and pan-European authorities. This requires political capital and/or an environment that rewards change. And therein lies one of the intrinsic difficulties of the underlying transformations: the green and digital transitions and geopolitical fragmentation are formidable challenges, but in the short term their severity is not felt to the same degree as other crises that are more short-term in nature and in which the threat to Europe's survival is so palpable that the inertia and resistance to change can be overcome. The question, therefore, is how much political capital the 2024-2029 European term will be able to garner.

4. The European Investment Fund speaks of a «technology drain». See https://www.eif.org/etci/scale-up-financing-gap/index.htm.
5. DG Trésor (2024) cited in footnote 1.
6. N. Veron (2024), «Capital Markets Union: Ten Years Later», In-depth analysis, PE 747.839, requested by the ECON Committee (European Parliament).
7. The EDIS would protect the bank deposits of euro area citizens, regardless of which European country they are located in, and it would do so more evenly than the current national system for guaranteeing deposits. This would help to weaken the national link between the public sector and the financial system (the so-called doom loop, which amplifies and exacerbates economic recessions) and would help economic shocks to be better absorbed, thus improving the effectiveness of all economic policies.
8. It is yet to be ratified by the Italian Parliament. The ESM reform is intended to bolster the European Stability Mechanism, strengthening its role as a backstop in the event of bank resolutions, facilitating access to its credit lines and assigning it a greater role in country support programmes (alleviating the burden of the *Troika* [ECB, IMF and European Commission]).

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