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Outlook for the Spanish economy and NGEU funds*

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* English translation from the original in Spanish

Ladies and gentlemen:

My thanks to the Association for the Advancement of Management for their invitation. I would like to take this opportunity to set out the Banco de España's view on **the outlook for the Spanish economy**.

To do so, I will begin by outlining the **international setting**, where recent developments have been marked by **three major trends**.

First, despite the restrictive monetary policy stance and geopolitical uncertainty, global economic activity held up better than anticipated in 2023. Thus, according to the latest IMF forecasts, global growth slowed less than expected in 2023, declining to 3.2%, where it looks set to remain for the next two years. Nonetheless, there is significant disparity across geographic areas. For instance, the upward revision to GDP growth in the United States and China stands in contrast to the deceleration seen in the **euro area**, where **growth continues to look decidedly weak**.

Second, also worth noting is the continuation of the disinflation process worldwide, as the supply shocks of preceding years have gradually faded, although underlying inflation still looks to be somewhat stubborn in certain regions, such as the United States. The cumulative tightening of monetary policy also appears to have played a key role in keeping inflationary pressures in check.

Third, the global financial markets have been very lively in recent months, with gains in stock prices and rising long-term yields. At the same time, the central banks of the main advanced economies (including the European Central Bank) are expected to cut their policy rates before long, although in the case of the US Federal Reserve the dates envisaged for rate cuts have recently been put back.

Against this backdrop, economic activity in Spain was more robust than initially forecast in 2023, outperforming the euro area as a whole. Specifically, Spanish GDP rose by 2.5% in the year overall, in contrast to growth of barely 0.4% in the euro area. Also worth noting is the significant momentum seen in Spain in 2023 Q4, as growth gathered pace (increasing by 0.6% quarter-on-quarter), while remaining flat in the euro area over the same period.

However, the composition of the growth seen in late 2023 hints at some uncertainty, particularly in the case of investment and private consumption. Traditionally the mainstays of stable growth in any economy, these components looked to have performed worse than expected. **Over a longer time frame, investment has proven significantly less dynamic than activity since the pandemic, with the transport and housing components performing particularly poorly.** By sector, while the 2023 public investment-to-GDP ratio stood well above its pre-pandemic level, the private investment-to-GDP ratio remained more than 10 percentage points below that figure. Using data from the Banco de España's

Central Balance Sheet Data Office to analyse these developments at firm level,¹ it would appear that this state of affairs is in part attributable to the fall in the share of firms investing, particularly in the sectors hardest hit by the pandemic, as well as to the decline in investment in young firms.

Moreover, productivity remains notably weak, potentially acting as a brake on economic growth over the medium and long term. This sluggish productivity may be contributing to the rise in unit labour costs, which could undermine Spain's international competitiveness.

Against this backdrop, the latest short-term indicators suggest that economic activity in Spain should remain notably buoyant in the opening months of 2024. A similar conclusion can be drawn from the figures on social security registrations (up 0.7% in the first quarter) and the purchasing managers' indices (PMI), which, in their composite version, stood in March at their highest point since May last year.

Looking ahead, the outlook for growth in the Spanish economy in the coming years remains fairly encouraging. In particular, based on the Banco de España's latest projections, the GDP growth rate is expected to stand at 1.9% in 2024 and 2025, before gradually converging towards levels more in keeping with the Spanish economy's growth potential towards the end of the projection horizon (with GDP growth of 1.7% in 2026). Noteworthy among the factors underlying these projections are the gradual reactivation of the European economy as the negative impact of monetary policy tightening slowly fades, the recovery in economic agents' real income, the population growth envisaged and the fiscal impulse from the Next Generation EU (NGEU) programme. Conversely, the notably weak investment and sluggish productivity of recent quarters will weigh on the future pace of output growth. Meanwhile, activity will be adversely impacted as certain tailwinds that have recently driven growth (relating to the correction of some of the supply side shocks that acted as a drag on activity in 2021 and 2022) peter out.

In terms of recent price developments, headline inflation (HICP) stood at 3.3% in March, as compared with 2.9% in February and 3.5% in January. The uptick in March can largely be attributed to the rise in the price of energy and, to a lesser extent, services. Indeed, **following 15 consecutive months of year-on-year falls, energy prices returned to positive growth rates, driven by electricity prices, which rose 6.9% year-on-year as the VAT on electricity returned to its standard 21% rate in March.**² Elsewhere, food prices continued to decelerate, growing by 4.3% in March, almost one percentage point less than in February. Meanwhile, underlying inflation fell by 0.2 pp year-on-year in March to stand at 3.1%, thanks to the slowdown in the price of non-energy industrial goods (with the year-on-year growth rate falling by 0.7 pp to 0.8%). This decline has been partially offset by the slight rise in services prices, which have hovered at around 4% for several consecutive months, partially owing to the performance of tourism-related services.

¹ See González Simón, M., Jiménez García, B. and C. Martínez Carrascal (2024). "Un análisis desagregado de la inversión empresarial desde el inicio de la pandemia", Artículos Analíticos, Boletín Económico, Banco de España, forthcoming.

² In accordance with Royal Decree-Law 8/2023 of 27 December 2023, VAT on electricity will be charged at 10% whenever the arithmetic average price on the day-ahead market in the preceding calendar month exceeds €45/MWh, and at 21% when the price is lower. This average price stood at €40/MWh in February, and the VAT rate therefore returned to 21% in March.

Looking ahead, the Banco de España's latest projections envisage inflation resuming a downward path in the coming months, owing to a gradual moderation in food and underlying inflation, which will more than offset the expected increase in the contribution of the energy component. Considering all these developments, headline inflation will gradually ease from an average of 3.4% in 2023 to 2.7% in 2024, 1.9% in 2025 and 1.7% in 2026. Underlying inflation, which in 2023 stood at 4.1% in annual average terms, will decline to 2.2% in 2024 before falling slightly further over the following two years.

The risks to these projections are on the downside as regards activity and are considered to be balanced with respect to inflation.

The main source of risk continues to be global geopolitical uncertainty and, in particular, a potential escalation in the ongoing conflicts in Ukraine and the Middle East. As regards the latter, the flare-up of tensions in the Red Sea region over the last few months has triggered a sharp increase in shipping costs, coupled with the risk of a possible escalation of the Iran-Israel conflict.

The impact of the cumulative monetary tightening on activity and prices is another significant source of uncertainty. The weakness of economic activity observed in the euro area in recent quarters – more pronounced than expected – could indicate a somewhat stronger transmission of monetary policy than envisaged. Also pointing in this direction are the downward surprises in lending to the private sector, of which there have been several in the last few quarters.

In addition, the reactivation and reform of the European fiscal rules poses a risk to the baseline scenario of these projections, which could prove significant for the Spanish economy, given its high public debt and structural deficit levels. Compliance with these rules will require the design and implementation of a **medium-term fiscal consolidation plan** that allows for a more pronounced correction of the structural public deficit than envisaged in the Banco de España's projections. Although the economic impact of this adjustment plan remains uncertain, and will crucially depend on how it is designed, its implementation would likely result in slower economic momentum over the projection horizon. This impact could be lessened if the adjustment went hand in hand with ambitious structural reforms.

Other significant sources of uncertainty surrounding the baseline scenario of these projections can be found closer to home and relate to potential second-round effects on inflation. First, a larger than expected increase in wages and/or profit margins would entail a higher inflationary path than envisaged under the baseline scenario of these projections. Although no signs of feedback loops between prices and wages and/or profit margins have been observed so far, it is important to continue monitoring this situation. This is particularly relevant in a setting in which compensation per employee is outpacing wage settlements and the labour market is showing signs of considerable strain.³

³ See [Ghomi, Hurtado and Montero \(2024\)](#).

Lastly, added to these risks is the uncertainty regarding the use of the European funds linked to the NGEU programme.

First, I would like to reflect on some aspects relating to the execution of this programme so far, and the effects that might be expected going forward.

According to official sources, funds totalling €34 billion have been allocated to date in NGEU-related public tenders, i.e. close to half the grants expected under the Recovery and Resilience Facility (RRF), the centrepiece of NGEU, pending the roll-out of the loan component.

Although no data for assessing the real impact of these funds on the economy is yet available, the evidence suggests that RRF tenders are being awarded to larger firms than those that have won previous public tenders (not related to the RRF). In addition to being larger, the awarded firms are significantly more productive and “older”, have better access to bank financing and saw a smaller drop in sales during the pandemic. By contrast, RRF grants are being allocated to firms that are comparatively smaller than has been the case with respect to other grants, which can be partly explained by the importance of the Digital Kit.⁴

These reflections on the RRF public tender and allocation process are particularly relevant insofar as the economic impact of an equal amount of economic stimulus may differ depending on the composition of the recipient firms. Thus, a public tender process that is biased towards small firms could help ease their financial constraints and accelerate their growth.⁵ Conversely, if it is skewed towards larger firms, the economic impact could be more immediate, since their productivity levels are already higher.

Second, the RRF’s main focus is on investments relating to the digital and green transition, which could trigger a far-reaching process of cross-sector reallocation. According to recent studies, a significant portion of the funds’ economic impact (around a third of the total) could stem from the propagation of the economic stimulus measures through the Spanish economy’s sectoral interdependencies.⁶ It is therefore vital to ensure that this process of cross-sectoral reallocation is as flexible as possible, assisted by a reduction in labour market rigidities that may constrain firms’ ability to fill high-skilled vacancies.

⁴ See Aguilar García, E., Alloza Frutos, M., Mata, T. D. L., Moral Benito, E., Portillo-Pampin I., and D. Sarasa-Flores (2023). [Una primera caracterización de las empresas receptoras de fondos NGEU en España](#). Documentos Ocasiones, 2321, Banco de España.

⁵ See Giovanni, J. D., García-Santana, M., Jeenas, P., Moral Benito, E. and J. Pijoan Mas (2022). [Buy Big or Buy Small? Procurement Policies, Firms’ Financing and the Macroeconomy](#). Documentos de Trabajo, 2233, Banco de España.

⁶ See Fernandez-Cerezo, A., Moral-Benito, E. and J. Quintana (2024). “On the macroeconomic impact of NGEU funds and its propagation through the production network”. *Economic Modelling*, vol. 132.

Third, the transformative impact of the RRF funds ultimately hinges on **selecting projects that can increase Spain's productive capacity**. These projects should have a strong innovation component and a high degree of complementarity with private investment.⁷

Summing up, designing and implementing the NGEU programme is a significant challenge for the public sector. Both short-term growth and the medium and long-term growth potential of the Spanish economy will largely depend on the ability to effectively and efficiently manage the large volume of NGEU funds coming into Spain. Critical to achieving this is the rigorous selection of projects, along with a real-time assessment process in place to allow possible shortcomings to be identified and remedied as they arise, in both procedural issues and funded projects. The enormous complexity underlying the management of these funds demands a great deal of transparency so that the process ultimately strengthens people's trust in their institutions.

⁷ See Domínguez-Díaz, R., Hurtado, S. and C. Menéndez (2024). [The medium-term effects of investment stimulus](#). Documentos de Trabajo, 2402, Banco de España