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1. Maybe it's not just the economy...

This weekend's Congressional and Senate elections could well define, as Gordon Brown (former UK Prime Minister) has said, the future of Europe.

In 1992 Bill Clinton's "it's the economy, stupid" to George W. Bush went down in the annals of political history as a reference to the importance that voters seemed to attach to economic issues in their voting decisions. A good economic backdrop seemed to ensure the president's re-election, while the perception that the US economy was then sliding down the rails of a marked slowdown (which ended in a recession) implied the end of his term in office.

But it does not seem that, on this occasion, the economy is weighing as a defining element of the major voting trends in Spain: after overcoming a pandemic, the Spanish economy grew in 2021 and 2022 by more than 5% and, this year, it will close with an increase clearly above expectations, above 2%. And this after managing the effects of the pandemic in such a way as to reasonably contain the deterioration of the economy and employment, with ICO loans and the use of temporary lay-offs (ERTEs). Employment is heading into the summer at a record high, with more than 20 million employed and an unemployment rate below 14%, and the public sector has had a kind of "free bar" in public spending in recent years thanks to the greater general tolerance for its use, given the characteristics of the pandemic, the effects of the war in Ukraine and the management of the European Next Generation EU funds. Public pensions rose by almost 9%, mitigating the effects of rising inflation, and the public deficit, especially the so-called structural deficit (which takes into account the timing of the economic cycle) remains at very high levels.

And yet, as we said, the outcome of the elections is highly uncertain. The deterioration in disposable income that the high levels of inflation have meant for a good number of citizens is difficult to alleviate with the use of public resources. Moreover, to some extent, the use of budgetary policy (more spending) to "water down" the economy indiscriminately in order to alleviate the destructive effects of inflation is usually a bad recipe: it adds spending to a situation of tension already manifested by the dynamics of prices, accelerating it. Hence the need to concentrate public resource efforts on the most vulnerable groups and to let monetary policy do its job. We have not yet discovered another way to do this with as little impact and economic pain as possible, which may be no small thing.

Whatever the outcome of Sunday's elections, it will become clear that Clinton's phrase should surely have been qualified by a prior "sometimes". On other occasions, the asymmetrical distribution of the costs of inflation between different groups of citizens (for example, pensioners versus young people with their first job) or the appropriate explanation of initiatives of a more political nature ("only yes is yes", housing law...) may have even more relevance. Beyond the fact that, in times of difficulty, there are always those who claim to have magic, cross-cutting, effective and, above all, spectacular and surprisingly painless recipes.

2. Quo Vadis Europe?

Let's take a step back and return to the Europe that Gordon Brown says could be defining its future this weekend. The general election takes place at the start of Spain's EU Presidency. No doubt this could affect its relevance in terms of delivering results, as the political class is understandably busy with domestic politics. However, the capacity of the Spanish administration, with all its machinery, to deliver results once the strategy has been previously defined should not be underestimated.

There are four objectives defined by the Spanish Presidency of the EU for the second half of 2023. **Firstly**, to reindustrialise the European Union and guarantee its strategic autonomy. The context of international openness, which in the last five decades has become one of the main drivers of economic and social progress in the EU, seems to be coming to an end with the so-called "de-globalisation" resulting from the new geopolitical balances. This implies the need to find new ways to move Europe away from situations of excessive dependence on third countries in crucial areas such as energy, health, technology and food.

The **second** priority is to make progress on ecological transition and environmental adaptation. Curbing climate change and environmental degradation should also allow us to drastically reduce our dependence on non-renewable energy, and the government estimates that it will allow us to save up to 133 billion euros in fossil fuel imports by 2030.

Thirdly, Spain will prioritise the appropriate revision of the Multiannual Financial Framework 2021-2027 (the "European budget") and will work "to achieve a reform of the fiscal rules that will put an end to the *austerity* policies that did so much damage during the 2008 financial crisis". We address the issue of fiscal rules below, but a reform "that succeeds in advancing on the path of transparency and allows to combine the sustainability of public finances with the proper financing of the green and digital transitions", as the government wishes, will not be an easy task.

Fourthly and finally, the government has announced that, in a context marked by uncertainty and growing geopolitical tensions, strengthening European unity will be among the priorities of the Spanish Presidency. In this regard, it will advocate further deepening of the internal market, the completion of the banking union and the capital markets union. Spain will also work to improve and consolidate common instruments such as the Next Generation Funds, and to move towards a more efficient and coordinated management of migration and asylum processes.

Of the four objectives, let us dwell for a moment on the last two that do seem, to paraphrase Brown, to define Europe's future in the coming years. **Firstly, fiscal rules.** One of the consequences of the pandemic was the suspension of fiscal rules in Europe. This has allowed governments a certain "latitude" in the use of public resources that has subsequently extended to the management of the impacts of the war in Ukraine. The increase in public deficits and debt, as a consequence of the articulated responses, are well known and should be followed by a progressive return to the establishment of certain limits to budgetary policies, especially among those countries that are part of the monetary union (the countries that use the euro).

This transition, however, will be potentially contentious and not without tensions between countries. The interests of one group of countries in returning to a path of stability are countered by those who have embraced the view that the so-called '*austericide*' that was practised in response to the 2008-2012 crisis unnecessarily worsened the economic suffering inflicted.

The former will have to be prudent in their demands so that adjustments in public spending are neither too severe nor lacking in credibility. The latter should not forget that much of the increase in public debt that has been permitted and observed over the past four years has been on the shoulders of the purchases made by the European Central Bank, which today has on its balance sheet something like 30% of the public debt of the eurozone countries after these years of massive purchases.

Secondly, the change in fiscal rules is linked to the political dynamics of the Union and, in particular, **the presidencies of the European Union** to be held by Hungary (second half of 2024) and Poland (first half of 2025), which will follow the Belgian presidency (first half of 2024).

Two presidencies in a row of two countries that are highly problematic in terms of their pro-European commitment can have toxic effects. Recently, Hungary and Poland have coordinated to increase pressure to maintain the rule of unanimity in EU foreign and security policy. This is their response to a newly formed coalition (to which Spain belongs) pushing for the adoption of qualified majority voting and an end to the veto power, which makes decision-making 'at 27' increasingly difficult and turns the EU into a dysfunctional player on the global geopolitical stage.

The two countries have also teamed up again to stir up the migration debate. Morawiecki and Orbán have recently blocked the timid conclusions on immigration of the European summit in Brussels, with which EU leaders sought to push forward agreements with countries of origin and transit (such as the one with Tunisia) to prevent migrants from reaching EU territory in exchange for economic aid packages.

Let us hope that in both cases (fiscal rules, presidencies) European leaders will contradict Henry Kissinger who, in 2018 in an interview in the Financial Times, stated

that "in the 1940s European leaders had a clear idea of where they wanted to go. Today what they want is basically not to have problems"¹ .

3. The economy is holding up... and it will hold up.

In the second half of 2023, the world economy is torn between a slowdown without major consequences and a recession triggered by central bank interest rate hikes as the necessary "medicine" to bring inflation (and the inflation expectations of economic agents) back to more acceptable levels.

In recent months, activity levels have shown some stagnation in the euro area and the United Kingdom, while in the United States it has been positive, supported by consumption dynamics and the use of surplus savings. Overall, one of the best pieces of news in this context is that employment levels remain strong in both Europe and the US, with unemployment rates at record lows.

Inflation levels have been progressively easing, but are still above central banks' targets. In this context, monetary policies have continued with interest rate hikes: towards 4% in the euro zone and 5% in the US. And they are not likely to be the last, although we should be close to peak interest rates in this cycle.

The reason for this near peak is that i) inflation levels have started to ease, ii) confidence levels in the manufacturing sector, which act as leading indicators of what lies ahead, point to a certain weakening of activity in the coming quarters, and iii) sectors with a high weight in the economy and very sensitive to interest rate levels are starting to show weakness (as is the case of real estate and construction).

We would expect the second half of 2023 and the first half of 2024 to be somewhat weaker than we have seen so far, although the European and US economies should be able to avoid recession, once the risks of a financial spiral discussed in the previous Economic Note have been averted.

4. Spain... is still different

In this context, the Spanish economy continues to recover and grow above the European average on the back of: i) employment, which has maintained a good tone, supporting private consumption, ii) tourism, which has recovered strongly and is expected to have a record summer, above 2019 levels, iii) household savings, which have continued to use the volume accumulated during the pandemic (although this effect should soon be exhausted), and iv) public spending, which continues to show a clearly expansionary character, also on the shoulders of European funds.

Growth forecasts have been revised upwards (with estimated growth for 2023 above 2% compared to 0.9% for the euro area), while the fall in inflation to below 3% has allowed real spending capacity to increase given the positive evolution of wages. Even so, the

¹ "In the 1940s, the European leaders had a clear sense of direction. Right now they mostly just want to avoid trouble".

effects of the withdrawal of some of the support measures that were adopted in the wake of rising inflation (e.g. tax reductions such as VAT on some products) will need to be monitored, as they could encourage price rebounds in the coming months.

The forecasts for 2023 and 2024 are therefore not bad, and despite the fact that this second half of the year may be somewhat weaker than the first, the Spanish economy will continue to grow at reasonably healthy rates... given the circumstances.

ENDNOTE: Neither this note nor any of its contents have been generated by ChatGPT.