

Economic note

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1. 2023 ends...

The global economy sailed reasonably well in 2023 and ended up growing by almost 3%. This period was marked by persistently high levels of inflation, compared to previous years, and rising geopolitical tensions in several regions. The escalation of the war in Ukraine was compounded by the conflict in Israel, in a historically conflict-ridden region. Russia produces 13 per cent of the world's crude oil, while the Middle East region is responsible for another 40 per cent. As a result, suddenly, more than half of the world's oil production was in notoriously more unstable areas than usual.

But this is not all. The strategic importance of the Suez Canal, the epicentre of the new source of tensions, lies in the fact that about 15% of world trade transits through it, accounting for about 30% of global container trade and being particularly important in the flow of crude oil and liquefied gas.

Tensions in this region have already had a noticeable impact on freight rates: according to some reports, costs per container on the Asia/Europe route have risen from around \$1,500 to around \$4,000/4,500. Recall that during the post-pandemic period, the increase in container prices from \$1,500/2,000 to over \$10,000 served as a prologue to the price increases that ended the low rates of inflation to which we had become accustomed.

2. and 2024 brings challenges for the global economy

Tensions in the Middle East could intensify the dynamics of "de-globalisation" that we have analysed in previous editions of this 'Economic Note' and that will continue to define and mark our time, also in 2024. However, geopolitics and its impact on de-globalisation will be accompanied by other factors, both emerging and already consolidated.

First, the growing urgency of the climate crisis persists in a context in which international collaboration is becoming even more difficult. Just when the response to the climate challenge should be more internationally coordinated given the size of the challenge, the world seems to be increasingly "uncoordinated" compared to the last three decades.

On the other hand, the introduction of generative Artificial Intelligence (gAI) for commercial purposes is another prominent feature of 2024, with obvious impacts in various sectors and fields. One example is NVIDIA, the leading Californian company that manufactures semiconductors capable of AI processing and also produces 80% of high-performance graphics processors. Its capitalisation reached \$1.47 trillion in 2023, a figure comparable to Spain's GDP (of 2021). In contrast, the IBEX-35, which groups the 35 largest listed Spanish companies, has a total value of approximately USD 0.72 trillion.

This dynamic reinforces the increasing concentration of corporate power in the hands of a few companies, a phenomenon known as "the winner takes it all". A further example is the S&P-500 index - the most representative of the US economy by grouping the 500 largest US companies - which increased by 10% in value during 2023. The seven largest companies in the index (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla and Meta Platforms), most of which are in the technology sector, increased 92% in value over the year. If we discount this increase from the overall increase in the value of the index, we obtain a value close to zero. Consequently, without the contribution of these seven "moguls", the rest of the index would have performed almost flat.

Moreover, in 2024, de-globalisation, geopolitics, the challenge of climate change and corporate concentration will be compounded by political polarisation, the paradigm of which will be the US presidential election in November. To some extent, a Trump victory - an option not currently ruled out - could strengthen the above-mentioned dynamics.

3. The Spanish economy... fine, thank you

As we anticipated in our last Note, the Spanish economy has ended 2023 with a positive performance, also standing out against the Eurozone. The labour market remains strong, imbalances in the private sector are moderate and the current account balance, indicative of the imbalances with the rest of the world, shows a small surplus sustained for several years, which is expected to persist in 2024. GDP growth closed 2023 at around 2.5%, and the expansion is expected to continue in 2024, albeit at more moderate rates, slightly below 2%.

As for inflation, the good figure of 3.6 % recorded in 2023 could be exceeded by the end of 2024, with a current estimate of between 3.2 and 3.4 %. At the same time, the unemployment rate could fall below 12% over the course of 2024 and close at an average of 11.5%, levels not seen since the onset of the financial crisis in 2008.

In recent months the complexity of the international environment has been offset to some extent by expectations of lower interest rates in developed countries, including Spain, due to

improvements in inflation levels. Thus, in the euro zone, headline inflation would have ended 2023 below 3% and projections suggest that it could be close to 2% by the end of 2024.

This improvement in inflation expectations has had a significant impact on investors' expectations for the evolution of central bank policy rates in 2024. In early 2024, expectations are for the European Central Bank (ECB) policy rates to decline by 1% to 1.5% over the course of the year, starting with reductions in June and reaching levels of 3% in December.

Despite the possibility that the vision of a rapid and sustained decline in inflation may not materialise and thus not lead to such a rapid reduction in ECB interest rates, expectations of lower rates and less dynamic price growth should boost the economy later this year, reinforcing the expectation of reasonable economic growth in 2024.

In this context, only two shadows seem to be cast over the Spanish economy in 2024: one external and the other domestic. The first relates to the geopolitical environment, which, as mentioned above, could deteriorate further, complicating global trade flows and the willingness of companies and investors to undertake investment projects. A deterioration in international trade conditions, such as a blockade or inability to navigate the Suez Canal, for example, could affect the cost and availability of tradable goods, jeopardising the anticipated general trend in inflation levels in developed countries and, in particular, in the Eurozone.

4. The return of the "fiscal cliff"

The second shadow hanging over the Spanish economy is of a fiscal nature. Although the Spanish economy performed very well in 2019, just before the pandemic, with 2% growth, employment generation, reduction of external imbalances, moderate inflation (0.7%), record tourism and a steady decline in the unemployment rate, that same year the public deficit exceeded 3% of GDP and public debt rose to 98% of GDP.

Although the pandemic had a colossal impact, with GDP contracting by 11.3% in 2020, by 2023 pre-pandemic levels had been recovered, with 2019 levels almost 2% higher. However, public debt reached 108% of GDP in 2023 and the deficit is expected to close slightly above 4%, even in a context of high revenue growth, driven by rising inflation. According to the European Commission, Spain's economic growth could be slightly below 2% by 2024, with unemployment falling and the public deficit still above 3%. All of this is partly supported by the arrival of European funds.

That, at this point in time, and with the growth figures of the Spanish economy in recent years, the imbalance of the public accounts is still close to 4% should be a cause for heated discussion. Surprisingly, however, it seems to be an absent element in the debate on economic policy in the country.

In recent years, the discussion about fiscal and budgetary policy and, in particular, the role of the public deficit has been marked by the "suspension" of fiscal rules in the European

Union as a consequence of the pandemic. Existing restrictions, which limited the use of fiscal policy and public spending by EU member states depending on the state of their public accounts, were put on hold when governments were confronted with the unprecedented challenge of COVID and its potential economic effects.

It is undeniable that the backing of fiscal (and monetary) policy against the virus had very positive effects, preventing the destruction of jobs and small and medium-sized enterprises across Europe. Public spending increased significantly (e.g. in Spain, through spending on ERTes, increased credit and loans from the ICO, etc.), which helped to curb the negative effects, while at the same time public revenues fell due to the lack of activity. The consequent increase in public deficit and debt was able to take place thanks to the greater flexibility provided by the suspension of fiscal rules.

This suspension of the rules was accompanied by the recognition, prior to the pandemic, that the formal framework established by the EU in relation to the rules was too rigid and complex. It was necessary to simplify it, make it understandable, adapt it to the realities of the different countries and, at the same time, make it more effective.

The agreement to modify the fiscal rules in Europe, reached at the end of 2023, under the Spanish presidency of the EU, largely complies with these premises: more gradual adjustments, consideration of the initial situation of the countries and contemplation of expenses related to the EU's long-term political objectives (digital transformation, energy transition, social protection and defence, among others).

The problem lies in the fact that a significant part of the European political class seems to have assumed that the combination of three events in recent years allows "escaping" from a rigorous and long-term fiscal policy. These events are: i) the fiscal response to the financial crisis between 2008-2012, considered deeply flawed for causing an overly demanding, abrupt and unfair adjustment of public spending; ii) the positive effects (true, as we said) of the economic policy response to the pandemic, with very large increases in public spending; and iii) the lack of real market discipline, facilitated by the massive purchases of public debt by central banks in Europe in recent years, particularly by the ECB in the case of the euro countries.

However, the sum of these events does not make it possible to avoid fiscal discipline and the need for rigour and a long-term vision. The response to the international financial crisis may have been excessive, but there was no alternative to significant fiscal adjustment in many countries. The positive results of the response to COVID are not applicable to a more "normal" situation. Finally, central banks' purchases of public debt have already started to decline and a return to "monetary normality" will require that a significant part of the debt, currently held by central banks, be returned to investors, who will exercise (via purchases and sales depending on the fiscal situation of each country) the market discipline that has been absent in recent years.

In view of the above, it is crucial, if not urgent, that the country initiates a discussion about budget and public spending that recognises this new reality from 2024 onwards. On the basis of current data, the European Commission warned last November that Spain's fiscal situation is "very difficult" and called for a credible medium-term strategy. Although there are countries in worse conditions, this should not prevent addressing the debate.

The apparent lack of need to adjust fiscal policy is just that, apparent, and this need is likely to be the distinguishing feature of fiscal policy in different European countries through 2024. It is not impossible to achieve: Portugal is projected to have surplus public accounts in 2023 and 2024, with debt rapidly approaching a level below 100% of GDP.

If fiscal policy is managed in a way that recognises this new reality, the outlook for the Spanish economy in 2024 is positive, with the caution (and permission), as we have noted, of geopolitics.