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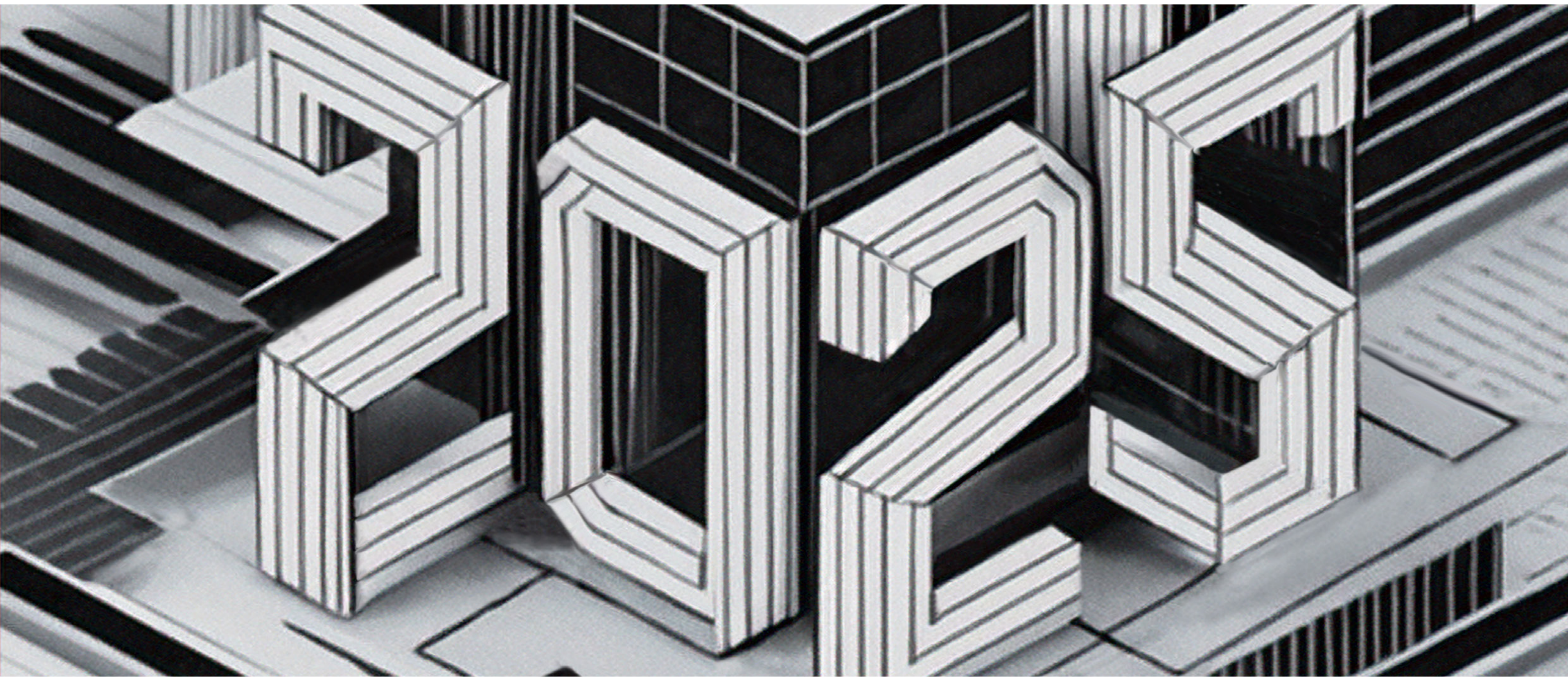
MONTHLY REPORT • ECONOMIC AND FINANCIAL MARKET OUTLOOK
NOVEMBER 2024



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MONTHLY REPORT - ECONOMIC AND FINANCIAL MARKET OUTLOOK
November 2024

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

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The Portuguese economy moves from less to more

Despite the volatility of Portugal's quarterly GDP growth readings, it is possible to glimpse a trend of acceleration, from less to more, in year-on-year comparisons. Indeed, the economy reached a momentum that can be considered weak, with an expansion of 1.4% year-on-year in Q1 2024, and has since accelerated to the 1.9% in the three months ending September, a trend we expect to continue in the coming months and throughout 2025, as we explain in this publication's Dossier. Lower financing costs, a robust labour market and the stabilisation of inflation at 2% will boost household consumption and investment, which will also benefit from healthier balance sheets, given the lower level of indebtedness and accumulated savings. On the other hand, speeding up the implementation of EU funds will be decisive, not only for investment performance in the short term, but also for strengthening the economy's capacity to generate value and potential output. Therefore, we anticipate a reinforcement of growth in 2025, slightly above 2% (2.3%).

The most recent activity indicators have evolved favourably, supporting our scenario, especially the aggregate confidence indices (such as the European Commission's or INE's sentiment indicator), car sales, and the Bank of Portugal's daily activity indicator. The Activity Traffic Light, a synthetic indicator produced by BPI Research which we present in a note included in this publication, also points in the same direction, i.e. a slightly higher quarterly growth rate in activity than in Q3. All in all, we believe that our forecast for GDP in 2024 remains possible (1.7%), although the headwinds have strengthened recently, given the greater political uncertainty associated not only with the outcome of the US elections but also with the situation of some impasse in the government of EMU's largest economy.

As regards consumer prices, the trend has also been favourable. The inflation rate has fluctuated slightly above 2%, but is tending towards the target level. In October, the estimated inflation rate rose slightly to 2.3%, which was due to the more volatile components, namely food and energy. Therefore, we don't think our forecast for an average inflation rate of 2.4% at the end of 2024, slowing down to 2% in 2025, is in doubt. Prices on futures markets for raw materials and food products support this forecast for the time being, which the other analysts agree on.

In relation to the labour market, there have been historically high employment levels, with the unemployment rate hovering just above 6% and an active population that remains in a phase of expansion. Employment increased by more than 1% year-on-year in 3Q2024, reaching a high since the international financial crisis. This means that the unemployment rate at the end of 2024 could be slightly lower than our forecast of 6.5%. By sector, and in the first nine months of the year, it can be seen that services are primarily responsible for job creation, with Wholesale Trade, Education and Public Administration having significant weight, followed by Communications, Consulting and Scientific Activities. On the other hand, Industry has made a negative contribution and the construction sector shows a slight annual gain, contributing only 5% of the total gain in employment. It should also be noted that the prospective indicators for the labour market are somewhat mixed, since job vacancies at employment and vocational training centres, for example, are lower than in previous years. However, companies continue to report a lack of skilled labour as one of the main obstacles to activity.

After a few quarters of evident moderation, the residential real estate segment has finally shown signs of recovery in the second half of the year. According to the prices reported by Confidencial Imobiliário, 38,050 properties were transacted in the 3rd quarter, marking a 6.7% increase from the previous quarter. Prices experienced a 2.5% increase during the same period, marking a slight acceleration from the 1.8% increase observed in the second quarter. The market may maintain a certain dynamism, partly due to demand from non-residents, and reflecting the reduction in financing costs. This factor could potentially boost the market in a context of reduced household leverage.

In short, the Portuguese economy continues to show good progress not only in cyclical terms, but also in structural terms, which as a whole is reflected, for example, in the improvement in the external account balance - the current account reached 2.7% of GDP in the first nine months of 2024 - or in the narrowing of the sovereign debt risk premium - which has evolved around 50 basis points for the European *benchmark*. As we have been saying, these are important assets in a somewhat complex global context that is unlikely to ease in the short term, especially given that Portugal is a small economy, significantly exposed to the outside world.

Paula Carvalho
November, 2024

Chronology

OCTOBER 2024

17 The ECB cut interest rates by 25 bps and lowered the depo rate to 3.25%.

SEPTEMBER 2024

12 The ECB cut interest rates 25 bps, placing the depo rate at 3.50% and the refi rate at 3.65%.
18 The Fed cut interest rates 50 bps, placing them in the 4.75%-5.00% range, having raised them 500 bps since March 2022.

AUGUST 2024

1-5 Strong turbulence in the financial markets triggered by the Bank of Japan's decision and worse-than-expected employment data for July in the US.
12 OPEC revises its forecasts for global oil demand in 2024 and 2025 slightly downwards, mainly due to slowing consumption in China.
23 The Fed will begin cutting interest rates in September, according to Powell's speech in Jackson Hole.

JULY 2024

26 The Olympic Games begin in Paris.
31 The Bank of Japan announces a surprise rate hike to 0.25% (up from the previous 0.0%-0.1% range), marking the highest level since late 2008.

JUNE 2024

2 OPEC agrees to extend its cuts to crude oil production (3.66 million bpd through to December 2025 and 2.2 million bpd to September 2024, but with a gradual withdrawal through to September 2025).
6 The ECB cuts rates by 25 bps, placing the depo rate at 3.75% and the refi rate at 4.25%.

MAY 2024

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

Agenda

NOVEMBER 2024

4 Portugal: public debt (Q3).
5 Spain: registration with Social Security and registered unemployment (October).
6 Portugal: employment (Q3).
6-7 Federal Open Market Committee meeting.
7 Spain: industrial production (September).
8 Spain: Fitch rating.
13 Portugal: labour cost (Q3).
14 Japan: GDP (Q3).
15 Portugal: Moody's rating.
19 Portugal: balance of payments (September).
22 Spain: loans, deposits and NPL ratio (September).
28 Spain: CPI flash estimate (November).
Euro area: economic sentiment index (November).
29 Spain: DBRS rating.
Portugal: GDP breakdown (Q3).
Euro area: CPI flash estimate (November).

DECEMBER 2024

2 Portugal: industrial production (October).
3 Spain: registration with Social Security and registered unemployment (November).
10 Portugal: international trade (October).
12 Governing Council of the European Central Bank meeting.
17 Spain: quarterly labour cost survey (Q3).
17-18 Federal Open Market Committee meeting.
19-20 European Council meeting.
23 Spain: quarterly national accounts (Q3).
Spain: loans, deposits and NPL ratio (October and Q3).
Spain: balance of payments and NIIP (Q3).
Portugal: GDP breakdown (Q3).
Portugal: home prices (Q3).
26 Portugal: NPL ratio (Q3).
28 Spain: CPI flash estimate (December).
Spain: household savings rate (Q3).
29 Portugal: CPI flash estimate (December).

Fluid times: a solid economy?

At the speed at which events are unfolding in today's geopolitical world, it is difficult to distance ourselves from the teeming reality and reflect on the medium-term economic outlook and trends. Only in the first week of November (at the time of writing) did we see a resounding victory for Trump and the Republican Party in the US Senate and House of Representatives, at the same time as the coalition government in Germany, one of the countries potentially affected by the protectionist turn expected from the new US administration, was definitively dismantled. Thus, in just over 24 hours, the level of uncertainty about the future economic policy of two of the world's major powers has increased considerably. In these fluid times in which we live, in which a moderately stable, repetitive and even boring economic and political environment has given way in the last fifteen years to a reality that is changeable, unpredictable and subject to a continuous process of transformation, it is necessary, from time to time, to stop and reflect on the major trends for the near future.

That's what we try to do every November in our annual Outlook Dossier. We are aware that these ideas and projections will be put to the test by the economic and geopolitical reality. Starting with a search for the new normal in the behaviour of the global activity cycle that we anticipate in 2025, understood as the elimination of the gap between supply and demand that has been present for a good part of the last five years. This will consolidate the return of inflation to something close to the target range (2%) and, consequently, bring interest rates closer to neutral levels (2% in the eurozone and 3% in the US). Since the oil market also seems to have an equilibrium price in the 70/80 dollar range, the conditions are in place to consolidate the soft landing of the world economy (growth of just over 3%).

In this context, central banks will have to manage the easing phase of monetary policy, progressing with the withdrawal of unconventional measures, regulating the speed at which interest rates are reduced to the neutral zone, and monitoring the effects of the easing of financial conditions on financial stability. In any case, after fifteen years of excessive emphasis on the monetary side, economic policy will have to be reoriented across three dimensions (as the IMF has just pointed out), through: a fiscal policy that seeks to stabilise debt dynamics (which is particularly complicated in the United States and China), a monetary policy that moves from the restrictive zone to neutral territory (good news for emerging countries), and supply-side policies that regain prominence to improve potential growth capacity. This is the best way to tackle old problems that had faded amid the fog caused by inflation, such as low potential growth, high levels of global public debt (over 100 trillion dollars), or the mediocre performance of productivity, especially in Europe.

Despite such a complex global context, it seems to us that the growth of the Portuguese economy could strengthen in 2025 (2.3%) because the engines that sustain growth are still active. Starting with the recovery in household purchasing power which, together with the fall in interest rates (and accumulated savings), will allow private consumption to remain strong. Then there are the favourable effects of demographics and the dynamism of the labour market. If, in addition, investment in infrastructure ends up reflecting the boost from NGEU funds and improved financing conditions, all this could more than offset the more modest contribution from external demand, which will continue to constrain national exports. In short, in fluid geopolitical times, let's hope that the economy remains reasonably resilient and robust next year.

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	4.50	3.25
3-month SOFR	3.62	0.99	0.21	4.74	5.37	4.16	3.07
12-month SOFR	3.86	1.42	0.52	5.48	4.95	3.62	3.10
2-year government bonds	3.70	0.99	0.67	4.30	4.46	3.60	3.35
10-year government bonds	4.69	2.44	1.46	3.62	4.01	3.80	3.80
Euro							
ECB depo	2.05	0.15	–0.50	1.77	4.00	3.00	2.00
ECB refi	3.05	0.69	0.00	2.27	4.50	3.15	2.15
€STR	–	–0.55	–0.58	1.57	3.90	2.93	2.01
1-month Euribor	3.18	0.42	–0.60	1.72	3.86	2.93	2.04
3-month Euribor	3.24	0.57	–0.58	2.06	3.94	2.94	2.06
6-month Euribor	3.29	0.70	–0.55	2.56	3.93	2.77	2.12
12-month Euribor	3.40	0.86	–0.50	3.02	3.68	2.60	2.18
Germany							
2-year government bonds	3.41	0.27	–0.69	2.37	2.55	2.15	2.05
10-year government bonds	4.30	1.38	–0.31	2.13	2.11	2.10	2.00
Spain							
3-year government bonds	3.62	1.53	–0.45	2.66	2.77	2.41	2.32
5-year government bonds	3.91	2.01	–0.25	2.73	2.75	2.50	2.41
10-year government bonds	4.42	2.96	0.42	3.18	3.09	2.90	2.80
Risk premium	11	158	73	105	98	80	80
Portugal							
3-year government bonds	3.68	3.05	–0.64	2.45	2.33	2.62	2.53
5-year government bonds	3.96	3.63	–0.35	2.53	2.42	2.63	2.56
10-year government bonds	4.49	4.35	0.34	3.10	2.74	2.80	2.75
Risk premium	19	297	65	97	63	70.00	75
EXCHANGE RATES							
EUR/USD (dollars per euro)	1.13	1.26	1.13	1.06	1.09	1.12	1.13
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	76.0	73.5
Brent (euros/barrel)	36.4	60.6	66.2	76.8	70.9	68.1	65.0

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	3.3	3.1	3.3
Developed countries	*2.7*	*1.0*	*5.7*	*2.6*	*1.7*	*1.7*	*1.8*
United States	2.7	1.5	6.1	2.5	2.9	2.6	1.9
Euro area	2.3	0.3	6.2	3.4	0.5	0.7	1.3
Germany	1.6	0.8	3.6	1.4	–0.1	0.0	0.7
France	2.3	0.3	6.8	2.6	1.1	1.1	1.2
Italy	1.5	–1.0	8.8	4.8	0.8	0.5	1.0
Portugal	1.5	–0.2	5.6	7.0	2.5	1.7	2.3
Spain	3.6	–0.2	6.7	6.2	2.7	2.8	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	1.1	1.0
Emerging and developing countries	*6.4*	*4.4*	*7.0*	*4.1*	*4.4*	*4.2*	*4.2*
China	10.6	7.5	8.5	3.0	5.3	4.6	4.0
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	2.5	1.8
Mexico	2.3	0.7	6.1	3.7	3.2	2.1	2.1
Russia	–	1.0	5.9	–1.3	3.7	3.1	1.3
Türkiye	5.5	4.3	11.4	5.5	5.1	3.4	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	5.7	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	2.9	2.0
Euro area	2.2	1.3	2.6	8.4	5.4	2.4	2.2
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	1.3	2.0
Portugal	3.1	1.0	1.3	7.8	4.3	2.4	2.1
Spain	3.2	1.2	3.1	8.4	3.5	3.0	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	2.6	2.3
Emerging and developing countries	*6.7*	*5.5*	*5.9*	*9.8*	*8.3*	*7.9*	*5.7*
China	1.7	2.6	0.9	2.0	0.2	0.4	1.4
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	6.6	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	4.9	5.6	2.0	2.2	1.7
Government consumption	2.2	–0.2	3.8	1.7	0.6	1.0	0.8
Gross fixed capital formation	–0.4	–0.8	7.8	3.3	3.6	1.3	5.7
Capital goods	3.4	2.3	16.0	7.2	5.7	–	–
Construction	–1.3	–2.2	6.6	0.9	1.3	–	–
Domestic demand (vs. GDP Δ)	1.3	–0.4	6.0	5.0	1.7	1.8	2.3
Exports of goods and services	5.2	2.3	12.0	17.2	3.5	4.2	5.0
Imports of goods and services	3.6	1.6	12.3	11.3	1.7	4.6	5.0
Gross domestic product	**1.5**	**–0.2**	**5.6**	**7.0**	**2.5**	**1.7**	**2.3**
Other variables							
Employment	0.4	–0.6	2.2	3.3	2.3	0.9	1.3
Unemployment rate (% of labour force)	6.1	11.1	6.7	6.1	6.5	6.5	6.4
Consumer price index	3.1	1.0	1.3	7.8	4.3	2.4	2.1
Current account balance (% GDP)	–9.2	–2.7	–0.8	–1.2	1.4	1.2	1.4
External funding capacity/needs (% GDP)	–7.7	–1.5	1.0	–0.2	2.7	2.8	3.1
Fiscal balance (% GDP)	–4.5	–5.2	–2.8	–0.3	1.2	0.5	0.3

Forecasts

Spanish economy

	Average 2000-2007	Average 2008-2020	2021	2022	2023	2024	2025
Macroeconomic aggregates							
Household consumption	3.7	–0.9	7.2	4.9	1.7	2.5	2.5
Government consumption	4.5	1.1	3.6	0.6	5.2	3.6	1.6
Gross fixed capital formation	5.7	–1.8	2.6	3.3	2.1	2.7	3.4
Capital goods	4.9	–0.9	3.3	2.9	1.1	1.8	4.3
Construction	5.7	–3.0	0.5	2.2	3.0	3.5	3.0
Domestic demand (vs. GDP Δ)	4.4	–0.9	6.9	3.9	1.7	2.4	2.4
Exports of goods and services	4.7	1.1	13.4	14.3	2.8	3.0	2.3
Imports of goods and services	7.0	–1.0	15.0	7.7	0.3	1.9	2.8
Gross domestic product	**3.6**	**–0.2**	**6.7**	**6.2**	**2.7**	**2.8**	**2.3**
Other variables							
Employment	3.2	–1.0	7.3	4.1	3.2	2.3	2.1
Unemployment rate (% of labour force)	10.5	19.2	14.9	13.0	12.2	11.6	11.2
Consumer price index	3.2	1.2	3.1	8.4	3.5	3.0	2.5
Unit labour costs	3.1	1.2	1.2	1.9	6.1	4.5	3.3
Current account balance (% GDP)	–5.8	–0.2	0.8	0.4	2.7	3.1	3.1
External funding capacity/needs (% GDP)	–5.1	0.3	1.6	1.1	3.6	4.1	4.1
Fiscal balance (% GDP)[1]	0.3	–6.8	–6.7	–4.6	–3.5	–3.0	–2.6

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

Forecasts

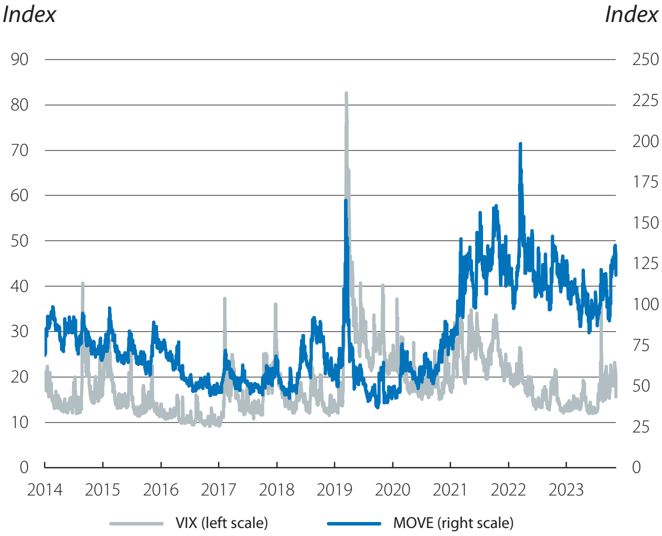
The markets: all eyes on the central banks and US elections

Sentiment improves in the US, but remains somewhat hesitant in the rest of the world. With all eyes on the US presidential election and the central banks' next steps, investors around the world spent October navigating choppy waters. In the US, the electoral uncertainty of October was combined with economic data that indicated a solid economy. This led investors to expect the Fed to take a slightly less dovish stance and to show a little more caution in the rate-cutting process. This adjustment in expectations, coupled with a slight increase in the inflation risk, resulted in a sharp upturn in sovereign yield curves and weighed down the major stock market indices. In the euro area, the macroeconomic data and the ECB's explicit acknowledgement of weak economic activity in the short term weighed on sentiment, which was also not immune to developments across the Atlantic. Meanwhile, in China, the lack of clarity regarding the stimulus plans left investors with a lower appetite for the country's risky assets. In this context of hesitant investor sentiment, Donald Trump's decisive victory in the US presidential election has appeared as a new catalyst, arousing the appetite for risky assets in the US and triggering rallies in the stock markets and an appreciation of the dollar. Although this had a certain knock-on effect on other risk-bearing assets around the world, their performance was more mixed amid investors' concerns about the prospect of trade conflicts and heightened uncertainty.

The central banks are making progress in the «gradual» monetary easing process. The ECB cut interest rates by 25 bps for the third time since June, bringing the depo rate down to 3.25%. This cut, which was agreed unanimously, was accompanied by a certain change of tone in the central bank's view of the economic outlook, with greater weakness anticipated in economic activity but, on the upside, more confidence in definitively overcoming inflation. The ECB was followed by the Bank of England, which cut 25 bps off the official rate, placing it at 4.75%, while its governor Andrew Bailey reiterated the intention to pursue a strategy of gradual reductions. To close the cycle of meetings, the Fed also lowered rates by 25 bps, bringing the fed funds rate down to the 4.50-4.75% range, after having kick-started the monetary easing cycle with an initial cut of 50 bps in September. The Fed's tone was cautious, pointing out that the economy's soundness allows it to steer interest rates towards neutral territory gradually and without haste.

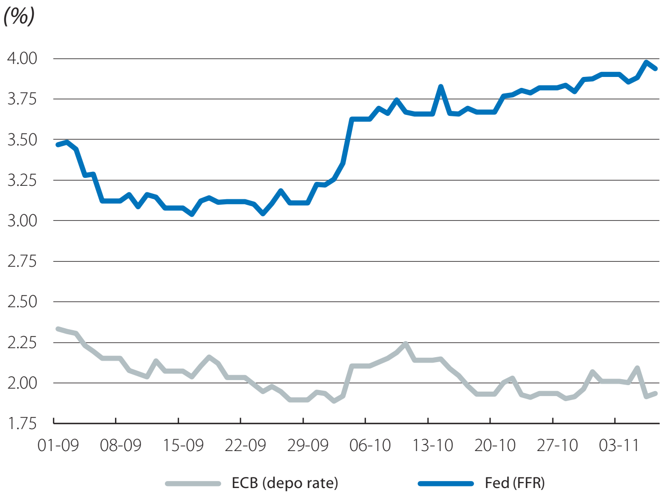
The markets see the Fed and the ECB cutting at different speeds. Given the economic context of the euro area (see the International Economy - Economic Outlook section), the futures markets shifted to anticipating a somewhat more dovish ECB than they had been expecting a few months ago, while in the US the more dynamic economic context caused a shift in expectations, with agents now anticipating a more cautious approach from the Fed in reducing rates. In particular, the markets shifted to anticipating a terminal depo rate in

Volatility in the financial markets



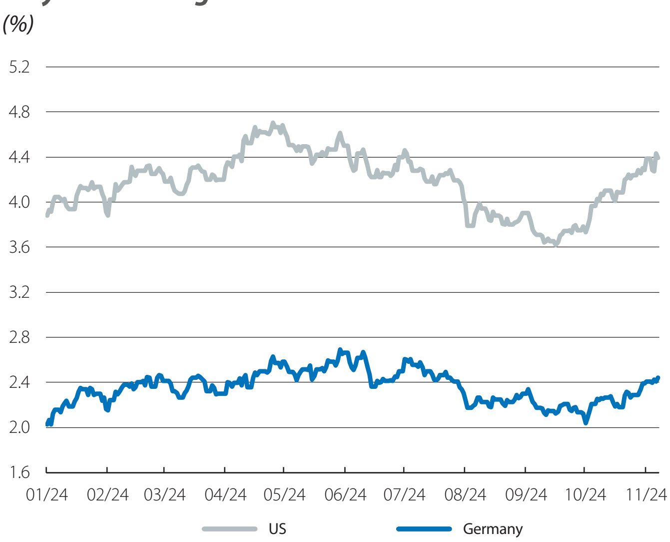
Source: *BPI Research, based on data from Bloomberg.*

Official interest rates expected for June 2025 according to the financial markets



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

10-year sovereign interest rates



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

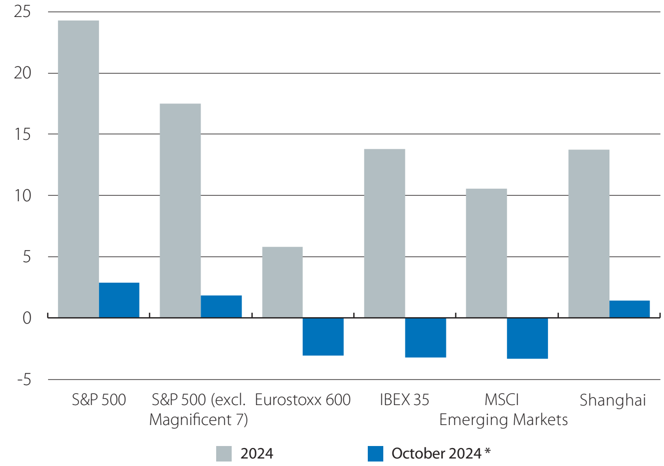
mid-2025 of 2% (vs. 2.25% at the end of the summer), with the fed funds rate expected to be in the 3.75%-4.00% range (3.00%-3.25% a month ago). This reduction of as much as 75 bps in the US was accompanied by a significant rebound in treasury yields throughout the length of the curve (+50 bps), with the 10-year benchmark reaching 4.40% (a level not seen since June 2024). Part of that rebound was due to the expectation of higher future inflation following Donald Trump's victory, given some of the key measures he announced while on the campaign trail. Sovereign rates in the euro area were not immune to their US counterparts, and despite expectations of a more dovish monetary policy, 10-year German sovereign rates rose by around 30 bps between the beginning of October and the time of writing, while rates in the periphery climbed around 20 bps.

Greater volatility and regional divergence in the stock markets. The electoral uncertainty and high interest rates adversely affected the stock markets of the major developed economies during much of October. Emerging markets, meanwhile, faced an additional volatility factor due to uncertainty surrounding the economic stimulus policies in China. At the end of October, the main stock market indices recorded widespread losses. However, following Trump's victory, the so-called «Trump trade» drove a recovery in US indices, which reversed the trend. The S&P 500 and the Nasdaq rebounded by as much as 4% in the two days after the election, reaching new all-time highs. Although gains were recorded across the board, it was the sectors that are expected to benefit the most from the Trump Administration's policies, such as energy and industry, which led the charge. In contrast, the Trump trade had a more mixed effect on other global markets. Shares in the euro area initially reacted with a correction (although they regained the lost ground in subsequent sessions), reflecting the sensitivity of the European economy, which is highly export-oriented and still highly exposed to China, to a potential environment of restrictive trade relations. The biggest losses were concentrated in companies with a high exposure to tariffs, such as German automakers, and in Spanish banks, given this sector's significant exposure to Latin America, especially Mexico.

The dollar gains strength, supported by rate spreads. The dollar appreciated more than 3% (from the beginning of October up until the close of this publication) against its major developed-economy counterparts. Against emerging-market currencies (the JP Morgan EMCI), the dollar has gained more than 1% since the US elections, especially against the Mexican peso, although it failed to undo the appreciation of over 3% accumulated by this group of currencies in October. Against the euro, the dollar traded within a narrow band from 1.08 to 1.09 since early October and reached 1.07 following the US election result.

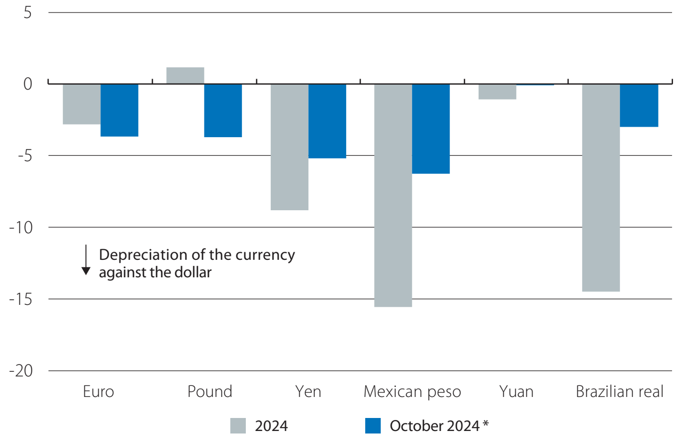
Mixed tone among commodities. The oil price remained relatively moderate and the Brent barrel fluctuated around the 75-dollar mark, in an environment of increased supply and downward revisions for demand, despite the pressure of the geopolitical conflicts. Among other commodities, the natural gas TTF benchmark rose moderately above 40 euros, while the indices for agricultural products and industrial metals recorded declines with respect to the end of September.

International stock markets
Cumulative change in the period (%)



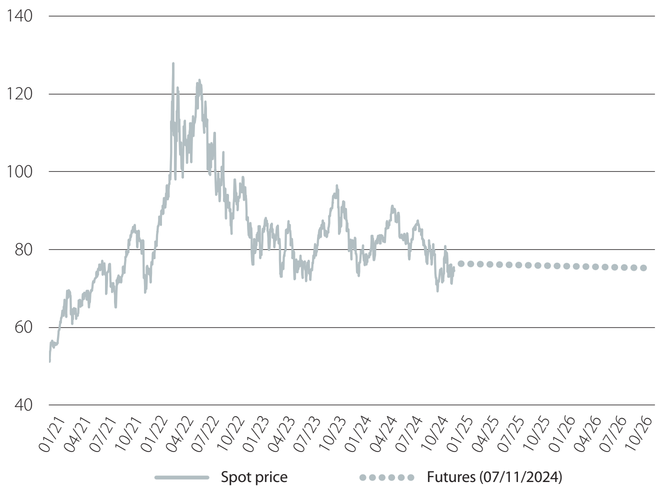
Note: ** Change throughout all of October and up until 6 November.*
Source: *BPI Research, based on data from Bloomberg.*

International currencies against the US dollar
Cumulative change in the period (%)



Note: ** Change throughout all of October and up until 6 November.*
Source: *BPI Research, based on data from Bloomberg.*

Brent barrel price
(Dollars/barrel)



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

Balance sheets: the not-so-visible normalisation of monetary policy

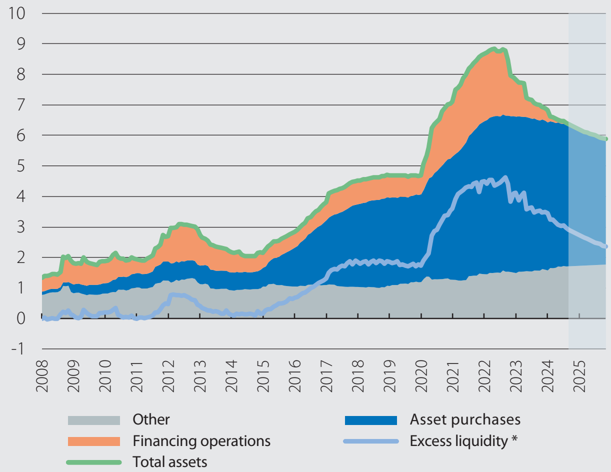
2025 should be the year of monetary policy untightening, with the ECB and the Fed lowering their interest rates to neutral levels (around 2% and 3%, respectively).[1] These rate cuts will be accompanied by another, less visible normalisation: the reduction of their balance sheets, which have grown exponentially in the last 15 years.

What is going on?

The balance sheets of the ECB and the Fed peaked in mid-2022, reaching almost 65% and 35% of the respective GDPs. As soon as they reached these highs, the inflationary crisis caused both central banks to end the asset purchases with which they had stimulated the economy and to begin to shrink the size of their balance sheets. This reduction process has accelerated and we estimate that, by the end of 2024, the ECB and Fed balance sheets will have decreased in size by 30% and 20%, respectively.

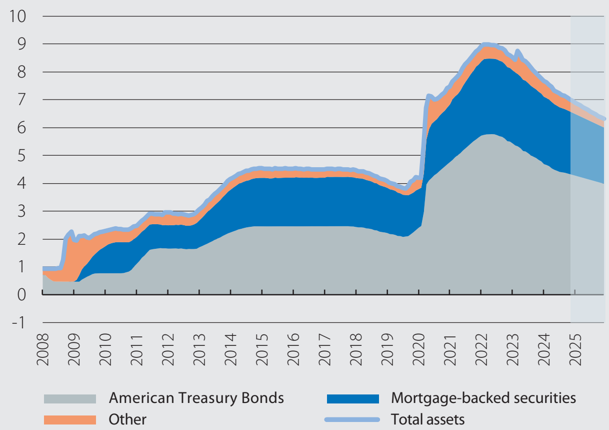
On both sides of the Atlantic, the contraction of the balance sheets has been carried out through a passive strategy that consists of not renewing the assets that reach maturity (but not selling assets before they reach maturity either).[2] So far, the markets have digested this approach well, without causing any dysfunction or turbulence and without compromising the monetary easing that has begun with the latest rate cuts. In the case of the ECB, the reduction began with the end of TLTRO-III, liquidity injections into the banking system which were made available between 2019 and 2021 and matured between 2021 and 2024.[3] In 2023, the process was accelerated with the end of reinvestments under the APP, the first major asset purchase programme launched in 2015 and with a portfolio amounting to almost 3.5 trillion euros: its reduction began with partial reinvestments in March 2023 and has continued passively since July 2023 with zero reinvestments.[4] Finally, the balance sheet reduction process reached cruising speed in 2024 with the end of reinvestments under the PEPP, the purchasing programme associated with the pandemic that amounted to 1.7 trillion euros.[5] With TLTRO-III already completed, and the APP and PEPP passively reducing in size, the ECB's balance sheet will continue to shrink in 2025, when we estimate it could stand at around 40% of GDP.

ECB: total assets on the balance sheet
(EUR trillions)



Note: ** Deposits in the deposit facility less use of the marginal lending facility.*
Source: *BPI Research, based on data from the ECB and internal forecasts.*

Fed: total assets on the balance sheet
(EUR trillions)



Source: *BPI Research, based on data from the Fed and internal forecasts.*

1. See the article «Monetary policy in 2025: dialling-back time» in the Dossier of this same *Monthly Report*.
2. J. Ihrig, L. Mize and G.C. Weinbach (2017). «How does the Fed Adjust its Securities Holdings and Who is Affected?», Finance and Economics Discussion Series 2017-099, Washington: Board of Governors of the Federal Reserve System, explain how this process works in detail. In the case of the Fed, when a $100 Treasury bond matures, the assets on the Fed's balance sheet are reduced by $100 (specifically, the heading «asset holdings of the Federal Reserve» is reduced). The Fed does not receive a cash income of $100, but rather the balance of the US Treasury account, within the Fed's liabilities, is reduced by $100 (the Treasury has an account with the Fed, where it can deposit funds to manage transactions related to taxes, for the issuance and payments of sovereign bonds, etc.). If the Fed wanted this maturity of $100 to not affect the size of its balance sheet, it could reinvest that $100 in the purchase of a new bond, which would once again increase both the holdings of assets (within its assets) and the Treasury account balance (within its liabilities) by $100.
3. TLTRO-III reached more than 2 trillion euros. The last operation remaining, for a sum of just 29 billion, matures in December 2024.
4. Initially, when a portfolio bond expired, the ECB allocated 100% of the principal received to new purchases, thus keeping the size of the bond portfolio stable. Between March and June 2023, the ECB reinvested only 15 billion euros per month (vs. average maturities of 32.6 billion), and since July 2023 it has not reinvested any of the 376.8 billion that has matured.
5. The ECB reinvested 100% of maturities up until June 2024. In July, it began to allow around 7.5 billion euros per month to mature without reinvestment, and it will cease all reinvestments at the end of 2024.

In the case of the Fed, the reduction began in June 2022, when it stopped reinvesting the Treasury bonds and mortgage-backed securities (MBSs) that expire each month, with an initial maximum value of non-reinvestments of 47.5 billion dollars per month (30 billion in Treasury bonds and 17.5 billion in MBSs). This reduction accelerated in September 2022, reaching a peak of 95 billion per month (60 billion in bonds and 35 billion in MBSs),[6] before finally slowing to 60 billion in June 2024 (25 billion in bonds and 35 billion in MBSs). This process has enabled the Fed to reduce its holdings of Treasury bonds by 1.4 trillion and those of MBSs by 0.4 trillion, to 4.4 trillion and 2.3 trillion, respectively. In 2025, we expect the Fed to maintain a similar pace[7] and that, by the end of next year, its balance sheet will stand at around 25% of GDP.

What are the challenges?

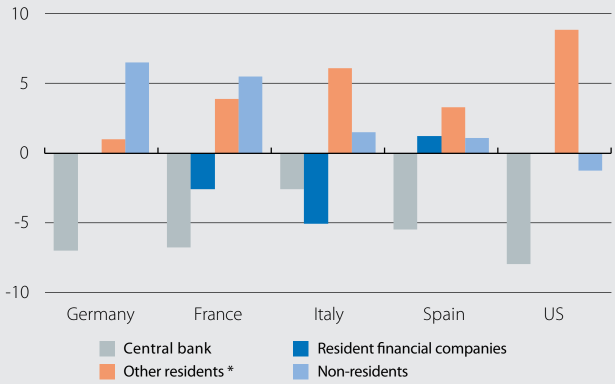
We expect that the balance sheet reduction processes will be gradual and that the total assets held by the Fed and the ECB will remain well above their pre-pandemic levels. Nevertheless, this does not mean that the process will be free of challenges.

One of the questions is the relationship between the size of the central banks' balance sheets and the abundance and distribution of liquidity in the financial system. In Europe, the reduction of the ECB's balance sheet will still leave us with significant excess liquidity.[8] Furthermore, anticipating the reduction in liquidity that will gradually become visible, not in 2025 but later, the ECB itself has revised its operating framework in order to avoid any future problems arising due to this lower liquidity.[9]

In the US, however, the situation is more uncertain. The Fed's goal is a system of «ample» reserves, whereby they would be less abundant than in the past but sufficient to allow the financial system to operate without liquidity restrictions while also ensuring that the fed funds rate is not materially sensitive to day-to-day changes in the total volume of reserves. Precisely where this equilibrium lies is difficult to estimate. On the one hand, the reserves have declined to 14% of GDP (versus a peak of 20% in 2021) and the Fed has suggested that a level of 10%-11% would be a good target,[10] meaning that there is still some way to go in the balance sheet reduction process. This is also suggested by an indicator produced by the New York Fed,[11] which estimates the sensitivity of the fed funds rate to changes in reserves and still places that sensitivity at practically zero. On the other hand, frictions have appeared in the money markets, such as the more-than-20-bp spike in the SOFR in a single day in September,[12] suggesting that liquidity may be less abundant than it might seem.

Holders of general government debt

Change in the share (of the total debt) between Q2 2022 and Q2 2024 (pps)



Note: ** Includes households, non-financial firms and public administrations.*
Source: *BPI Research, based on data from the Treasury departments of Germany, France, Spain and the US, the Banca d'Italia and the ECB.*

Finally, the withdrawal of the central banks' asset purchases eliminates a major bond buyer from the secondary markets. Over the past two years, the decline in ECB and Fed debt holdings has been significant, but at the same time this gap has been largely filled by demand from private investors. This is an encouraging trend and one that is expected to continue in 2025, despite the scale of the purchases that the Fed and the ECB plan to cease, as the comparison with the expected volume of debt issues shows (see last chart).

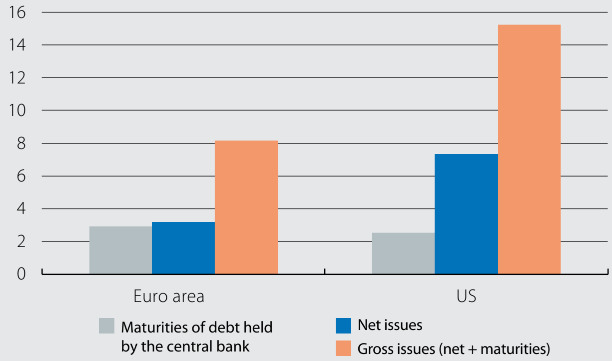
In short, in 2025 we should see the co-existence of a gradual reduction in Fed and ECB benchmark interest rates (causing monetary easing) with a smooth decline in the size of their balance sheets and in the amount of excess liquidity. The balance sheet reduction process helps to shrink the footprint of both central banks in the financial markets,[13] thereby mitigating the Fed and the ECB's exposure to credit and duration risks. Also,

6. In practice, the reduction in MBSs was lower, with maturities of 17 billion per month.
7. Average of 25 billion in treasuries and 17 billion in MBSs.
8. Based on the rate of reduction of the APP and the PEPP, excess liquidity is expected to reach 2.4 trillion euros by the end of 2025. Historically, only when this figure has fallen below 350 billion have signs of low liquidity appeared (e.g. the 1-day interbank rate becoming decoupled from the deposit facility rate).
9. See the Focus «The ECB, in the midst of a review» in the MR12/2023. In March 2024, the ECB officially introduced a system of liquidity on demand which enables abundant and well-distributed liquidity but with the central bank having a smaller footprint in the markets.
10. C. Waller. «A Conversation with Federal Reserve Governor Christopher Waller». The Brookings Institute, 2024.
11. See G. Afonso, D. Giannone, G. La Spada and J.C. Williams (2022, revised in 2024). «Scarce, abundant, or ample? A time-varying model of the reserve demand curve». Staff Report nº 1019, Federal Reserve Bank of New York.
12. This is the interest rate at which banks and other financial institutions take overnight financing and, therefore, it serves as a measure of how tight monetary conditions are.
13. This also helps alleviate shortages of collateral, thereby improving the functioning of markets such as that of repos, as well as reviving the financing markets.

although increasing the size of the balance sheets was a stimulus measure, their reduction in 2025 and in the years ahead is not expected to impose a monetary restriction that will interfere with the rate cuts or that will hold back the economy. Firstly, the balance sheet reduction process conducted during the course of 2022, 2023 and 2024 has been well received, and in these years the financial markets have taken the Fed and ECB benchmark rates (and not their balance sheets) as the guiding tool for monetary policy. Secondly, there are several reasons why the reduction and increase of their balance sheets do not have symmetric effects: (i) the balance sheet increases occur in turbulent times marked by disruptions in the functioning of the markets, while the reduction takes place in a stronger economic environment; (ii) the balance sheet increases serve to ensure that, in these turbulent times, the central bank makes clear its commitment to an accommodative monetary policy for a long time, whereas in the balance sheet reduction phase the Fed and the ECB have decoupled changes in their balance sheets from changes in rates, and (iii) the balance sheet increases are rapid and aggressive, while the reduction is slow and gradual, as the projections presented in this article show.

Sovereign bonds: maturities and issues in 2025

(% of GDP)



Notes: *Net issues are estimated using the IMF's public deficit forecast for 2025. The issues to renew maturities are estimated using the total stock of debt and its average term.*
Source: *BPI Research, based on data from the IMF (WEO, October 2024), the ECB, the US Treasury Department and the Fed.*

Interest rates (%)

	31-October	30-September	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Euro area					
ECB Refi	3.40	3.65	–25	–110.0	–110.0
3-month Euribor	3.06	3.28	–22	–84.7	–91.1
1-year Euribor	2.55	2.75	–20	–96.6	–148.0
1-year government bonds (Germany)	2.47	2.47	0	–79.6	–117.3
2-year government bonds (Germany)	2.28	2.07	21	–12.3	–73.4
10-year government bonds (Germany)	2.39	2.12	27	36.6	–22.7
10-year government bonds (Spain)	3.10	2.93	17	10.2	–56.8
10-year government bonds (Portugal)	2.80	2.70	10	14.4	–56.2
US					
Fed funds (upper limit)	5.00	5.00	0	–50.0	–50.0
3-month SOFR	4.56	4.59	–3	–77.2	–81.0
1-year government bonds	4.27	4.00	27	–49.3	–106.4
2-year government bonds	4.17	3.64	53	–8.0	–76.2
10-year government bonds	4.28	3.78	50	40.5	–20.8

Spreads corporate bonds (bps)

	31-October	30-September	Monthly change (bp)	Year-to-date (bp)	Year-on-year change (bp)
Itraxx Corporate	59	59	0	0.1	–17.6
Itraxx Financials Senior	65	67	–2	–1.6	–22.4
Itraxx Subordinated Financials	116	121	–5	–6.6	–46.1

Exchange rates

	31-October	30-September	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
EUR/USD (dollars per euro)	1.088	1.114	–2.3	–1.4	1.6
EUR/JPY (yen per euro)	165.480	159.940	3.5	6.3	2.3
EUR/GBP (pounds per euro)	0.844	0.833	1.3	–2.7	–3.2
USD/JPY (yen per dollar)	152.030	143.630	5.8	7.8	0.7

Commodities

	31-October	30-September	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
CRB Commodity Index	534.4	540.3	–1.1	4.7	–0.1
Brent ($/barrel)	73.2	71.8	1.9	–5.0	–8.0
Gold ($/ounce)	2,744.0	2,634.6	4.2	33.0	40.7

Equity

	31-October	30-September	Monthly change (%)	Year-to-date (%)	Year-on-year change (%)
S&P 500 (USA)	5,705.5	5,762.5	–1.0	19.6	30.2
Eurostoxx 50 (euro area)	4,827.6	5,000.5	–3.5	6.8	15.5
Ibex 35 (Spain)	11,672.6	11,877.3	–1.7	15.5	25.7
PSI 20 (Portugal)	6,532.8	6,792.9	–3.8	2.1	4.8
Nikkei 225 (Japan)	39,081.3	37,919.6	3.1	16.8	21.5
MSCI Emerging	1,119.5	1,170.9	–4.4	9.4	16.9

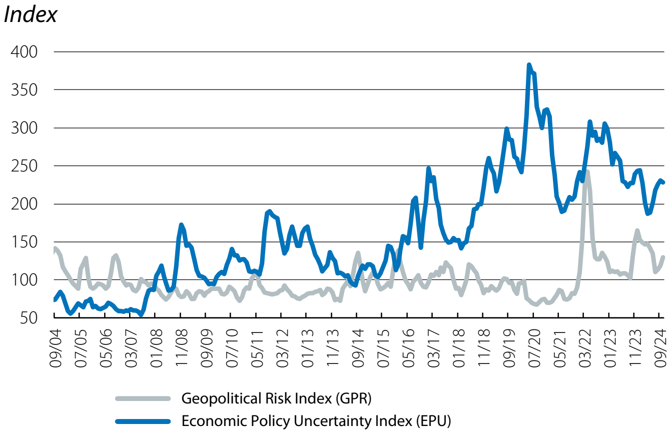
Uncertain times in the international economy

Stable economic outlook but with growing risks. In its autumn report, the IMF has highlighted an environment of continuing growth, in which the imbalances between supply and demand are fading, enabling a gradual decline in inflation without triggering a sharp correction in economic activity or employment. In this favourable economic context, there are significant differences in growth between regions and a considerable risk map, skewed to the downside. On the one hand, the persistent strength of the US economy and the good performance of the emerging Asian economies (excluding China) contrasts with the weakness shown by China, the large European economies and those most dependent on oil exports. On the other hand, as the main sources of danger the Fund identifies as key threats the possibility of new episodes of volatility in the financial markets, resistance in the disinflationary process, the increase in social tensions, and the rise of protectionism (a risk which is accentuated by the economic agenda proposed by the US president-elect Donald Trump). In particular, the IMF estimates that a scenario with widespread tariff increases, greater uncertainty and lower migration flows could subtract around 1% from world GDP between 2025 and 2026.

Geopolitical risk, uncertainty and lack of confidence. In an environment marked by high geopolitical risk, as well as uncertainty regarding the direction of global economic policy, confidence remains the Achilles' heel in the largest economies. In the European economy and in China, the deterioration of the confidence indicators is taking place amid a slowdown in economic activity. The case of the US, meanwhile, provides a clear example of how (a lack of) confidence at the global level can have a more fundamental root – and can eventually curb the economy – as long as perceived risk and uncertainty remain high. In addition, the IMF's Global Financial Stability Report identified the environment of high uncertainty as an additional risk to macrofinancial stability and a factor that could delay consumption and investment decisions. In this regard, in the US, the confidence indicator published by the University of Michigan has shown an improvement in recent months and stood at 70.5 points in October, although it still lies well below its historical average (around 85 points). In the case of China, consumer confidence remains close to record lows (85 points, compared to an all-time average of 108 points). In the euro area, the consumer confidence index stood at –11.2 points in October, confirming the improving trend of previous months, although it remains below its historical average (around –10 points). Meanwhile, the ESI sentiment indicator published by the European Commission fell again in October (to 95.6 points) and has also remained below its historical average since July 2022.

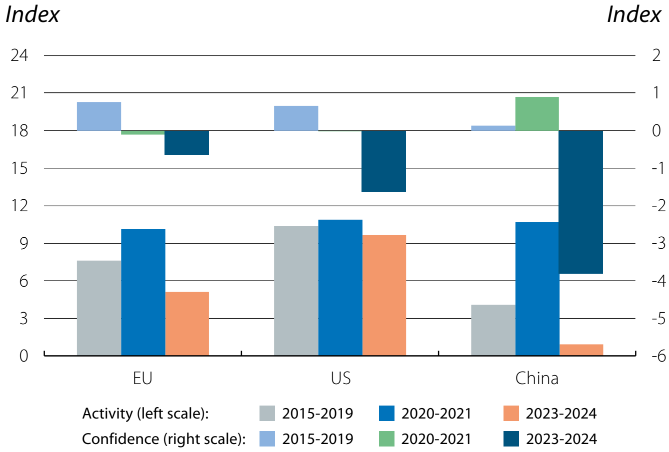
Q3 on the radar: no landing in the US while the euro area and China are still struggling to take off. In Q3, the publication of the GDP figures brought upside surprises in the largest economies. The euro area economy beat expectations by growing 0.4% quarter-on-quarter, after recording a modest growth of 0.2% in Q2. However, with the exception of Spain, which registered a significant growth of 0.8% quarter-on-quarter, the underlying picture is one of practical stagnation among the major European economies. Germany exceeded expectations by growing 0.2% quarter-on-quarter (but it

Global: geopolitical risk and uncertainty



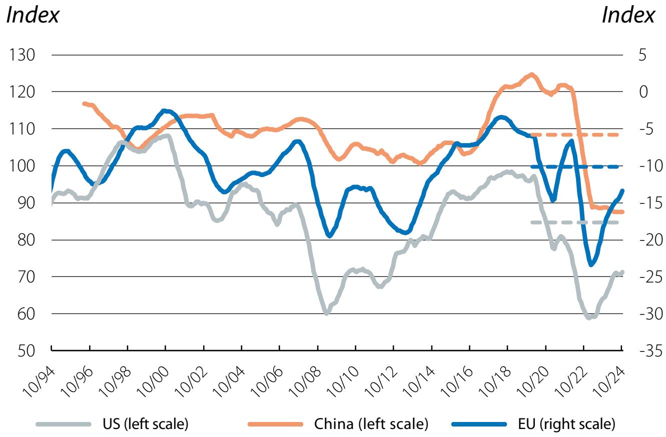
Note: The indices are constructed from newspaper articles, by searching for words related to geopolitical risk and uncertainty regarding economic policies. Both indices have a base of 100, corresponding to the average of the periods 1985-2019 (GPR) and 1997-2015 (EPU). The 3-month averages are shown.
Source: BPI Research, based on data from S.R. Baker, N. Bloom and S.J. Davis, (EPU) and Caldara, Dario and Matteo Iacoviello (GPR) (downloaded from https://www.policyuncertainty.com/index.html).

Global: TIGER activity and confidence indicators



Note: The TIGER indices use a statistical method (Principal Component Analysis, or PCA) to extract indicators that capture common trends across large data sets.
Source: BPI Research, based on data from the Brookings Institution (downloaded from https://www.brookings.edu/articles/october-2024-update-to-tiger-calm-on-the-surface-turbulence-beneath/

Global: consumer confidence



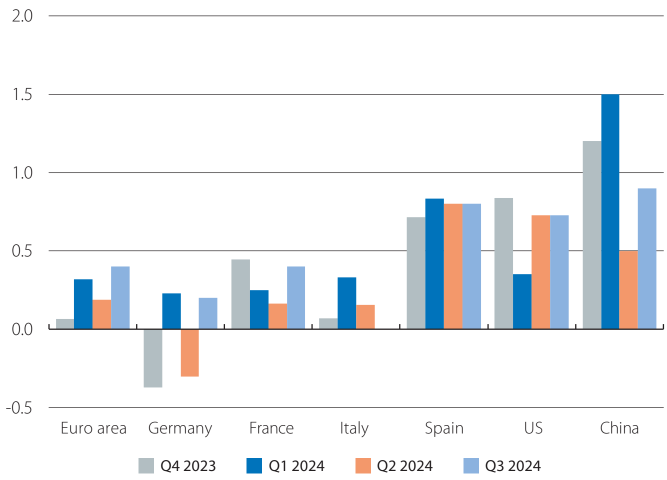
Note: In the chart, the dashed straight lines show the historical average of each series. For the US, the University of Michigan's Consumer Sentiment Index has a base of 100 in 1966. For China, the confidence index published by the National Statistics Office of China is used, with a base of 100 in 1997. For the EU, the European Commission's consumer confidence index has an historical average (1985-2024) of around –10 points (corresponding to the balance, in pps, of the responses of a sample of European households to questions about their personal finances and the wider economic situation).
Source: BPI Research, based on data from the University of Michigan, the National Statistics Office of China and the European Commission.

contracted 0.3% in Q2, revised 0.2 pps down from the initial estimate). France grew 0.4% quarter-on-quarter (versus 0.2% quarter-on-quarter in Q2), a result that can be explained by the effect of the Paris Olympic Games. For its part, Italy disappointed by stagnating in Q3. The figures for the euro area were also affected by the volatility of Ireland's data, which showed growth of 2.0% quarter-on-quarter (vs. –1.0% quarter-on-quarter in Q2). Across the Atlantic, the US economy maintained robust growth in Q3 (0.7% quarter-on-quarter, the same as in Q3), driven by strong private consumption, while investment slowed, weighed down by a decline in the residential sector. The Chinese economy, for its part, registered quarter-on-quarter growth of 0.9% in Q3 (vs. 0.5% in Q2). Despite this acceleration, the year-on-year rate observed in Q3 (4.6% vs. 4.7% previously) is the lowest since the beginning of 2023. In an environment in which the disinflationary pressures are accumulating and domestic demand is showing signs of weakness, the fiscal stimulus recently announced by the Chinese authorities may provide some cyclical support, but it does not substantially alter the underlying economic outlook.

The strength of services continues, but with no signs of recovery in manufacturing. At the start of Q4, the business sentiment indicators continue to reflect a clear disparity between the euro area and the US, as well as between the weakness of the global manufacturing sector and a more resilient services sector. October's composite PMI for the euro area stood at 50.0 points (49.6 in September), indicating a stagnation in activity. In the US, the composite index rose to 54.3 points (54.0 in September), placing it in expansive territory and offering a further sign of the buoyancy of the US economy. On both sides of the Atlantic, the manufacturing sector remains somewhat sluggish. In the euro area, the manufacturing PMI reached 46.0 points in October (45.0 previously), while US manufacturing, despite some improvement (47.8 vs. 47.3) remains far from the growth threshold. On the services side, the sector remains in expansive territory, although in the euro area it has lost some momentum (51.6 vs. 51.4) and in the US the index continues to show more vitality (55.3 vs. 55.2).

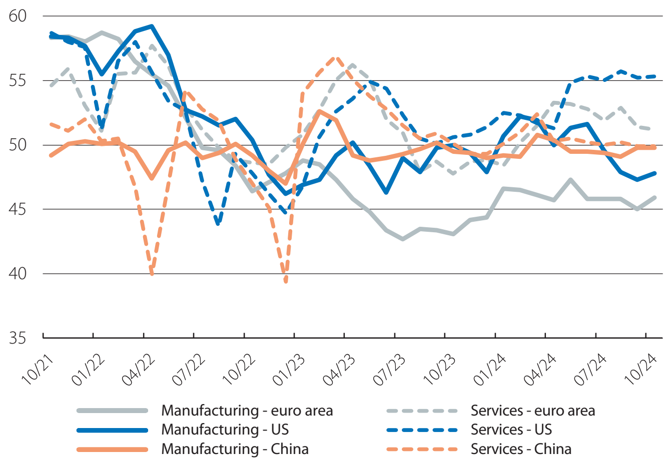
With inflation close to central bank targets, the global economy «pivots» towards old problems. In the euro area, headline inflation reached 2.0% year-on-year in October (vs. 1.7% in September), while the core index remained stable at 2.7%. This rebound is mainly explained by the rise in prices in more volatile components, such as energy and food, and does not contradict the underlying disinflationary dynamics. In the US, headline inflation fell 0.1 pp to 2.4% in September, while core inflation accelerated to 3.3% (vs. 3.2%), pressured by the persistence of prices in services. In particular, inflation in medical and transport services picked up again after several months of moderation, while the shelter component, which accounts for over 30% of the index, has moderated but remains high (4.9% in September vs. 5.2%). Faced with a return to normality in the main macroeconomic variables, the IMF suggests the need for a «triple pivot» in economic policy. Monetary policy must shift from being restrictive to neutral, fiscal consolidation must control debt dynamics and rebuild «buffers», while reforms are needed to improve growth and boost productivity.

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



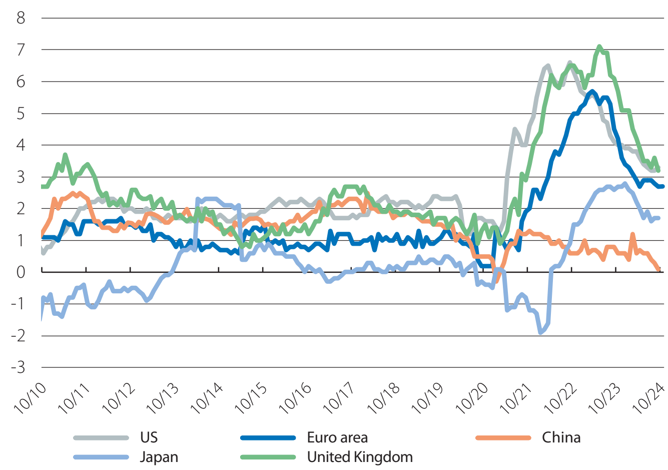
Source: *BPI Research, based on data from Refinitiv and Bloomberg.*

Global: PMI
Index



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

Global: core inflation
Year-on-year change (%)



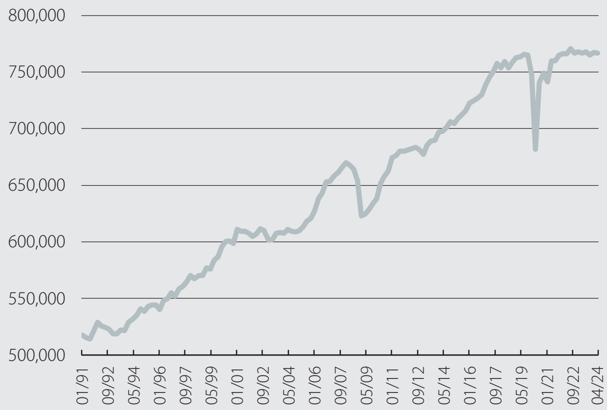
Note: *Core inflation excludes energy and food prices.*
Source: *BPI Research, based on data from Bloomberg.*

Germany: reinventing itself amid a new reality

Germany, the euro area's largest economy, is facing difficult times and a weak growth outlook. For many years, the strength of its economy was due to the success of policies aimed at promoting SMEs, its ability to produce high-quality goods (especially cars), cheap energy supplies and a highly export-oriented economy. This model, however, is threatened by the slowdown in world trade, tariff wars, the change in the energy model and the emergence of new rivals. In fact, Germany was the only economy in the G7 to go into recession in 2023 and, given the weakness it has been showing so far this year, we cannot rule out the possibility of it doing so again in 2024. During the decade of 2010-2019, Germany was one of the most dynamic economies, with an average growth of 2.0%. Since 2020, however, it has been practically stagnant, with only Estonia and Finland performing worse in the euro area. In fact, in Q3 2024, the German economy exceeded its pre-COVID level by only 0.2%, while France is already 4.1% above the level of Q4 2019, Italy is up 5.5% and Spain 6.6%. There are several elements that explain what is happening in Germany.

Germany: real GDP

(EUR millions)



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

Dependencies and dependencies with rivalry: gas, China and cars

Germany has been one of the economies hardest hit by the war in Ukraine as it has lost its supply of cheap Russian gas (which accounted for over 50% of its pre-war gas imports). The increase in energy costs (40 euros/kWh currently vs. less than 20 euros/kWh in 2010-2020) has put its industry at a disadvantage compared to other countries with more diversified energy markets. Moreover, the phasing out of nuclear energy, within the framework of the decarbonisation of the economy and the transition to renewable energies amidst an energy crisis, further increased costs for businesses. Thus, the most energy-intensive industries[1] are operating with activity levels almost 15% lower than prior to the war and some have moved part of their production abroad.

In addition, over the last decade Germany has developed close trade ties with China: it is the fourth largest market for German exports and the main source of all its imports. However, the trade relationship with China has evolved over time. Whereas at first Germany imported intermediate, capital and consumer goods and exported final products with the «made in Germany» stamp of quality (cars, machinery, chemicals, etc.), not only is China now able to produce many of the goods it previously acquired from Germany, but also, in some cases such as cars, it has become a serious rival. In less than six years, China has gone from having little relevance in the global automotive market to accounting for almost 16% of all exports of electric or hybrid vehicles, and almost 7% of internal combustion vehicle exports. In particular, the number of vehicles exported by China is more than double that exported by Germany in 2024 to date. This surge has been largely due to a highly aggressive pricing strategy, supported by significant public aid and subsidies provided by the Chinese government to its industry which exceed those implemented in other industrialised economies.

The increase in protectionist policies and the changes to global supply chains forced by the COVID pandemic pose an additional challenge for an economy as export-oriented as Germany's. Europe in general, and Germany in particular, are focusing on de-risking strategies,[2] and this entails enduring short-term difficulties as supply chains are restructured in order to reduce their dependence on imports from China and seek other European and non-European suppliers.

Low public investment and population ageing

On the other hand, Germany has an almost structural deficiency in public investment. Despite rising in the last decade, gross fixed capital investment is expected to still lie below 3.0% of GDP in 2024, placing Germany among the bottom three in the EU ranking for this measure. Successive governments have been reluctant to increase public spending and have sought policies consistent with achieving a positive fiscal balance;[3] so much so that in

1. Chemicals and chemical products, pulp, paper and printing, non-metallic minerals and base metals, which account for more than 15% of the manufacturing sector, and slightly less of total employment.

2. See the Focus «What will de-risking mean for the EU?» in the MR11/2023.

3. At the close of this report, the German government was planning to moderate expenditure growth to 2.25% in 2025 (3.75% in 2024), placing the fiscal deficit at 1.75% of GDP (2.5% estimated for 2024).

2009 the constitution was amended to include a fiscal rule, known as the «debt brake», which limits the annual structural deficit to 0.35% of GDP, unless there are exceptional circumstances. This debt brake was put on hold after the COVID outbreak in 2020, and this pause was extended with the outbreak of the war in Ukraine. However, in 2024 it was reactivated and this has significantly reduced the margin for investing in the energy transition, digitalisation and defence.

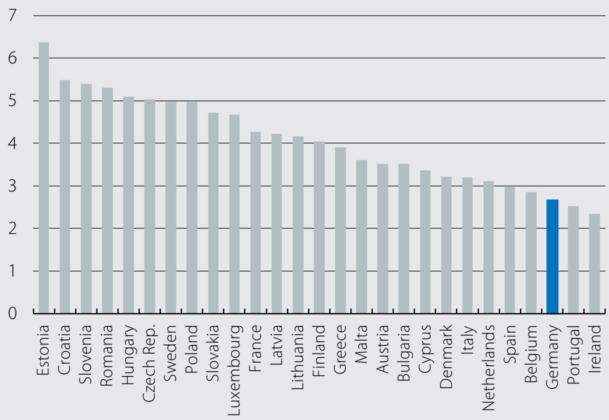
This commitment to fiscal orthodoxy has enabled Germany to enjoy sound public accounts: the country's fiscal deficits meet the 3.0% of GDP target and its debt is almost at the 60% threshold. Added to this strong fiscal position is the high level of savings accumulated by the private sector (more than 28% of GDP), which has allowed the current account balance to register a continuous surplus since 2002. The current account balance is also the highest in the euro area at present (and the second highest in terms of GDP), making it a significant potential source of friction with Germany's trading partners, especially the US. Moreover, as noted in the Letta report, these savings flow out of the country, which has led to Germany presenting a net creditor position (foreign financial assets in the hands of Germans less German liabilities in the hands of non-residents) of 60% of its GDP.

Finally, Germany faces a major demographic challenge, even in the short term: according to estimates by the European Commission, the working-age population (between 20 and 64 years) will fall by more than 6% by 2035; this is almost twice as much as the decline expected in Italy and contrasts with the anticipated increases of more than 3.0% and 1.8% in France and Spain, respectively.[4] This decline in the working-age population will intensify over the coming decades (likewise in the rest of the euro area), adding another obstacle to raising the economy's potential growth in the medium and long term.

Reforms in an environment of opportunities provided by Europe

Germany therefore needs to implement an ambitious agenda of economic reforms that will enable it to overcome the significant challenges it faces, and it has significant strengths to help it achieve this. Germany is among the leaders of the business climate rankings, with strong and reliable institutions and political stability that favour business investment. Its geographical position, in the centre of the EU, also favours it and it is the home of key industrial conglomerates (machinery, manufacturing, electronics, chemicals, automotive, etc.).

EU: public GFCF
(% of GDP in 2023)



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

In addition, now is a good time to initiate these reforms. On the one hand, the indebtedness of the country's private sector is quite low and it is in a very strong fiscal position. This would allow it to design a fiscal strategy that assures the sustainability of the public accounts in the medium term, while adjusting the debt brake clause to allow for more rapid increases in public spending.[5] On the other hand, Europe is immersed in the decarbonisation and digitalisation of its economy, a process epitomised by the NGEU funds. In addition, the Draghi report stresses the need for further progress to be made in this direction and lays the foundations for developing a new industrial policy at the European level.[6]

Despite the reluctance with which the Draghi report was received, the German government is aware of the delicate situation which the country finds itself in: the German car manufacturer Volkswagen, after publishing a 64% decline in net profits in Q3, announced for the first time in its history the closure of three plants on German soil. To make the outlook even more challenging, the coalition government has broken down as a result of stark differences over the key proposals to stimulate the German economy and the 2025 budget (still pending in parliament). After announcing the collapse of the coalition, Chancellor Scholz said he will call a vote of confidence on 15 January, paving the way for early elections in March (currently scheduled for 25 September 2025).

4. European Commission. 2024 Ageing Report.
5. See Galen Sher. «Options for Creating Fiscal Room for Investment and Other Spending Needs, Germany». IMF Selected Issues Paper (SIP/2024/034).
6. See the Focus «Draghi proposes a European industrial policy as a driving force to address the challenges of the coming decades» in the MR10/2024.

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

UNITED STATES

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Activity									
Real GDP	2.5	2.9	3.2	2.9	3.0	2.7	–	–	–
Retail sales (excluding cars and petrol)	8.6	5.3	5.0	2.9	3.4	3.5	3.5	3.7	...
Consumer confidence *(value)*	104.5	105.4	102.7	106.3	98.9	102.2	105.6	99.2	108.7
Industrial production	3.4	0.2	–0.1	–0.5	0.0	–0.4	–0.2	–0.6	...
Manufacturing activity index (ISM) *(value)*	53.5	47.1	46.9	49.1	48.8	47.1	47.2	47.2	46.5
Housing starts *(thousands)*	1,552	1,421	1,481	1,407	1,340	1,326	1,361	1,354	...
Case-Shiller home price index *(value)*	307	312	322	325	329	...	332	...	...
Unemployment rate *(% lab. force)*	3.6	3.6	3.7	3.8	4.0	4.2	4.2	4.1	4.1
Employment-population ratio *(% pop. > 16 years)*	60.0	60.3	60.3	60.2	60.1	60.1	60.0	60.2	60.0
Trade balance [1] *(% GDP)*	–3.8	–3.1	–2.8	–2.8	–2.8	–2.9	–2.9	–3.0	...
Prices									
Headline inflation	8.0	4.1	3.2	3.2	3.2	2.6	2.5	2.4	...
Core inflation	6.2	4.8	4.0	3.8	3.4	3.2	3.2	3.3	...

JAPAN

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Activity									
Real GDP	1.2	1.7	0.9	–0.9	–1.0	...	–	–	–
Consumer confidence *(value)*	32.2	35.2	36.5	38.9	37.0	36.8	36.7	36.9	36.2
Industrial production	0.0	–1.4	–0.9	–4.3	–2.9	–1.9	–3.3	–2.0	...
Business activity index (Tankan) *(value)*	9.5	7.0	13.0	11.0	13.0	13.0	–	–	–
Unemployment rate *(% lab. force)*	2.6	2.6	2.5	2.5	2.6	2.5	2.5	2.4	...
Trade balance [1] *(% GDP)*	–2.1	–3.0	–1.8	–1.2	–1.0	...	–1.0	...	...
Prices									
Headline inflation	2.5	3.3	2.9	2.5	2.7	2.8	3.0	2.5	...
Core inflation	1.1	3.9	3.9	3.2	2.2	2.0	2.1	2.0	...

CHINA

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Activity									
Real GDP	3.0	5.2	5.2	5.3	4.7	4.6	–	–	–
Retail sales	–0.8	7.8	8.3	4.7	2.6	2.7	2.1	3.2	...
Industrial production	3.4	4.6	6.0	5.8	5.9	5.0	4.5	5.4	...
PMI manufacturing *(value)*	49.1	49.9	49.3	49.7	49.8	49.4	49.1	49.8	50.1
Foreign sector									
Trade balance [1,2]	899	865	865	841	864	895	895	895	934
Exports	7.1	–5.1	–3.3	–1.7	4.4	5.4	8.3	0.3	12.5
Imports	0.7	–5.5	0.9	1.6	2.5	2.5	0.4	0.2	–2.3
Prices									
Headline inflation	2.0	0.2	–0.3	0.0	0.3	0.5	0.6	0.4	...
Official interest rate [3]	3.65	3.45	3.5	3.5	3.5	3.4	3.4	3.4	3.1
Renminbi per dollar	6.7	7.1	7.2	7.2	7.2	7.2	7.2	7.1	7.1

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	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Retail sales *(year-on-year change)*	1.4	–1.9	–0.7	–0.2	0.1	1.8	2.4	2.9	...
Industrial production *(year-on-year change)*	2.3	–2.1	–3.7	–4.8	–3.6	...	0.1	...	...
Consumer confidence	–21.9	–17.4	–16.7	–15.5	–14.3	–13.1	–13.4	–12.9	–12.5
Economic sentiment	102.1	96.3	94.8	96.0	96.0	96.2	96.4	96.3	95.6
Manufacturing PMI	52.1	45.0	43.9	46.4	46.3	45.5	45.8	45.0	46.0
Services PMI	52.1	51.2	48.4	50.0	53.1	52.1	52.9	51.4	51.6
Labour market									
Employment (people) *(year-on-year change)*	2.4	1.4	1.3	1.1	0.9	...	–	–	–
Unemployment rate *(% labour force)*	6.8	6.6	6.5	6.5	6.4	6.3	6.3	6.3	...
Germany *(% labour force)*	3.1	3.0	3.1	3.3	3.5	3.5	3.5	3.5	...
France *(% labour force)*	7.3	7.3	7.5	7.5	7.5	7.5	7.5	7.6	...
Italy *(% labour force)*	8.1	7.7	7.5	7.1	6.7	6.2	6.1	6.1	...
Real GDP *(year-on-year change)*	3.6	0.5	0.1	0.5	0.6	0.9	–	–	–
Germany *(year-on-year change)*	1.5	–0.1	–0.2	–0.1	–0.2	–0.2	–	–	–
France *(year-on-year change)*	2.7	1.1	1.3	1.5	1.0	1.3	–	–	–
Italy *(year-on-year change)*	4.9	0.8	0.3	0.3	0.6	0.4	–	–	–

Prices

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

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
General	8.4	5.5	2.7	2.6	2.5	2.2	2.2	1.7	2.0
Core	3.9	5.0	3.7	3.1	2.8	2.8	2.8	2.7	2.7

Foreign sector

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

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Current balance	0.0	2.1	2.1	2.6	3.1	...	3.4	...	...
Germany	4.4	5.9	5.9	6.2	6.5	...	6.4	...	...
France	–1.2	–1.0	–1.0	–0.5	–0.6	...	–0.5	...	...
Italy	–1.7	0.0	0.0	0.5	0.9	...	1.0	...	...
Nominal effective exchange rate [1] *(value)*	**90.9**	**94.7**	**95.1**	**95.2**	**95.2**	**95.6**	**95.7**	**95.5**	**94.8**

Credit and deposits of non-financial sectors

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

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Private sector financing									
Credit to non-financial firms [2]	6.7	2.7	0.1	0.3	0.4	0.8	0.8	1.1	...
Credit to households [2,3]	4.4	1.7	0.5	0.3	0.3	0.6	0.6	0.7	...
Interest rate on loans to non-financial firms [4] *(%)*	1.8	4.6	5.2	5.1	5.1	4.9	5.0	4.7	...
Interest rate on loans to households for house purchases [5] *(%)*	2.0	4.4	4.9	4.9	4.8	4.7	4.7	4.6	...
Deposits									
On demand deposits	6.3	–8.5	–10.7	–8.8	–5.5	–2.5	–2.5	–1.5	...
Other short-term deposits	4.5	21.1	21.1	18.5	14.4	10.5	10.4	9.7	...
Marketable instruments	3.7	20.3	19.9	20.5	19.7	21.8	22.3	21.8	...
Interest rate on deposits up to 1 year from households *(%)*	0.5	2.7	3.3	3.2	3.1	3.0	3.0	3.0	...

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.*

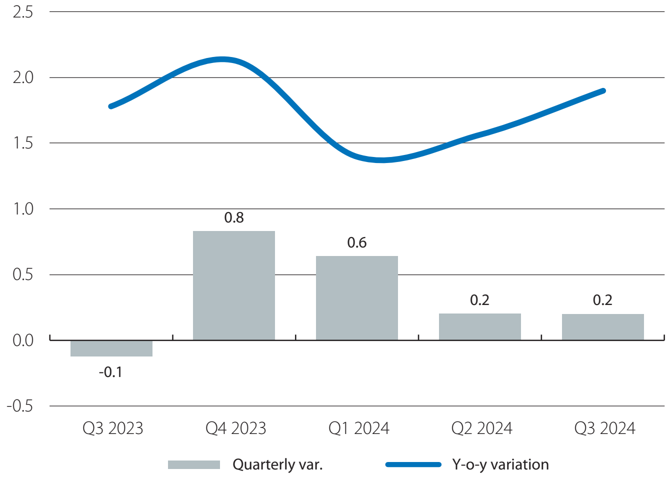
The final quarter of 2024 starts on a positive note

In Q3 2024, GDP grew by 0.2% quarter-on-quarter, putting year-on-year growth at 1.9%, in line with BPI Research forecasts. Preliminary information released by INE indicates that growth reflects the positive contribution of domestic demand, with advances in investment and private consumption, but that the contribution of net external demand remained negative. In year-on-year terms, the economy advanced by 1.9% in Q3, an acceleration compared to Q2, the result of a stronger contribution from domestic demand due to an acceleration in private consumption, but less strong growth in investment, in line with the monthly GFCF indicator. The contribution of net external demand was negative, with imports and exports accelerating compared to 2Q.

Q3 was marked by a trend from less to more during the quarter itself, which should continue until the end of the year, given the behaviour of the daily activity indicator, which showed an acceleration trend in October. Also in October, the economic climate indicator and the economic sentiment indicator improved again, as a result of an improvement in sentiment in services and construction. In turn, households were more cautious, but with a less favourable assessment of the country's economic situation over the next 12 months, while continuing to give a positive assessment of the expected evolution of their financial situation. Supporting this outlook is the resilience of the labour market, whose September figures show employment growing by 1.6% and the unemployment rate stabilising at 6.4%. For the year as a whole, we anticipate real GDP growth of 1.7%. The current forecast's risks are balanced, with negative factors primarily stemming from external geopolitical factors. Domestically, the risks appear to be more skewed to the upside, related to the possibility that domestic demand will prove stronger than anticipated.

Inflation in October rises, but underlying inflation moderates. Indeed, INE's flash estimate shows an increase in the overall CPI to 2.3% (2.1% in September). Meanwhile, underlying inflation fell again (to 2.6%) after the strong upward rebound recorded in September. The increase in overall inflation is essentially due to the monthly increase in the prices of the most volatile components – the energy index (+1.28%) and unprocessed food products (+0.92%). On the energy side, this wasn't surprising given two factors – the price of Brent crude oil, which resulted in an average increase of 2% in retail prices (average monthly increase in plain 95 petrol and plain diesel, as published by the DGEG); and ERSE's announcement that natural gas prices in the regulated market would increase by 6.9% (accompanied by some increases from operators in the free market). Despite the acceleration of the Global CPI, we see this data as benign: the monthly change in

Portugal: evolution of GDP
Rate of change (%)

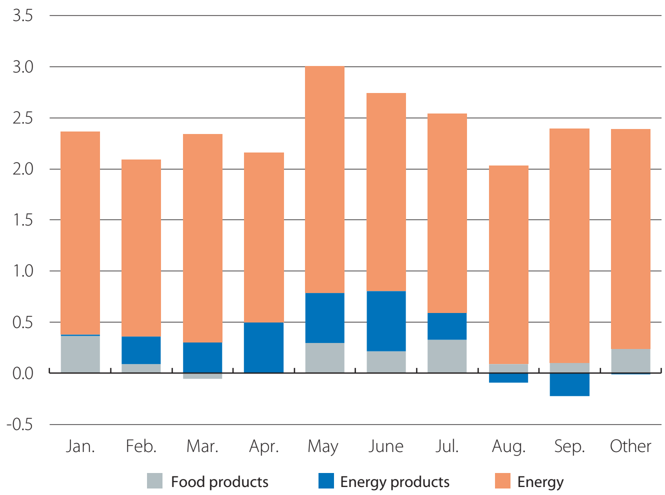


Source: *BPI Research, based on data from the National Institute of Statistics.*

Daily economic activity indicator
Average monthly year-on-year change (%)

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

IPC Portugal: contributions for year-on-year variation
(%)



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

prices was only 0.06%, which is much lower than the average for this parameter over the five years immediately prior to the pandemic (0.14%) recorded in October.

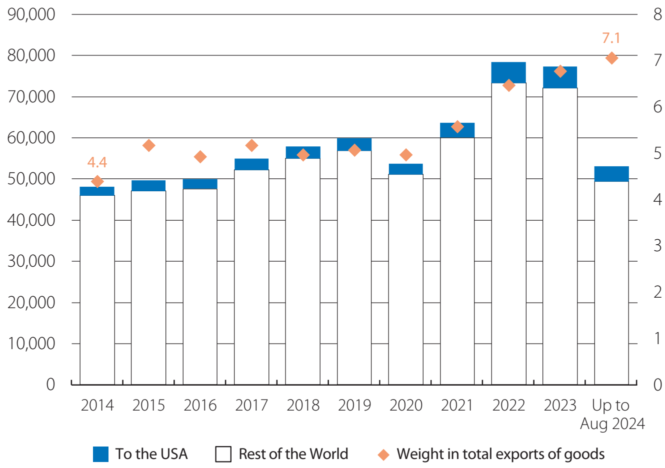
The flash estimate for international trade in Q3 2024 points to growth in exports and imports of 9.9% and 6.6% respectively. Confirmation of this data indicates that in the first 9 months of the year, exports and imports of goods grew by 2.3% and 0.5% year-on-year in nominal terms, respectively, continuing to contribute to the improvement in the trade deficit. Given the proximity of the US elections and the possibility that the new administration will adopt a more protectionist policy, increasing and/or extending tariffs on imported goods, this could have a negative impact on the Portuguese export sector, as the US market has been gaining weight in national exports. In 2024, 7% of national exports were destined for the North American market, with pharmaceutical products (23% of total exports to the US) and coke and refined petroleum products (21%) accounting for the majority.

Tourism continues to evolve positively. In September, the tourist accommodation sector registered 3.3 million guests and 8.4 million overnight stays, an evolution that represents year-on-year growth of 2.9% and 2.6%, respectively. This evolution was mainly based on tourism by non-residents, given that, in year-on-year terms, guests and overnight stays by residents fell slightly (–0.5% and –0.2%, respectively). Year-on-year growth in overnight stays in the year to September that is higher than year-on-year growth in Q3 2024 also indicates a slight reduction in seasonality. This performance is in line with our vision for the sector's evolution in 2024 with less exuberant growth rates and a contribution to GDP growth that we estimate at 0.7 p.p., more modest than in 2023 (1.1 p.p.).

Up until September, the general government account balance recorded a surplus equivalent to 2.8% of GDP (public accounts perspective). This compares with a surplus of 3.6% of GDP in the same period of the previous year and the shrinkage is the result of stronger growth in expenditure than in revenue. The former rose by 11.1% year-on-year, reflecting an increase in fixed expenditure, via pension updates and the updating of civil service salaries. In turn, revenue increased by 8.2%, particularly tax revenue and, more specifically, a 23.5% increase in corporate income tax revenue. The data published so far suggests that 2024 will end with a surplus equivalent to 0.6% of GDP, but the risks are not favourable, especially given the increase in spending on more rigid items (see Focus on the SB 2025 proposal «The budget balance is balanced, but the risks are still lurking» in this publication).

Exports of goods

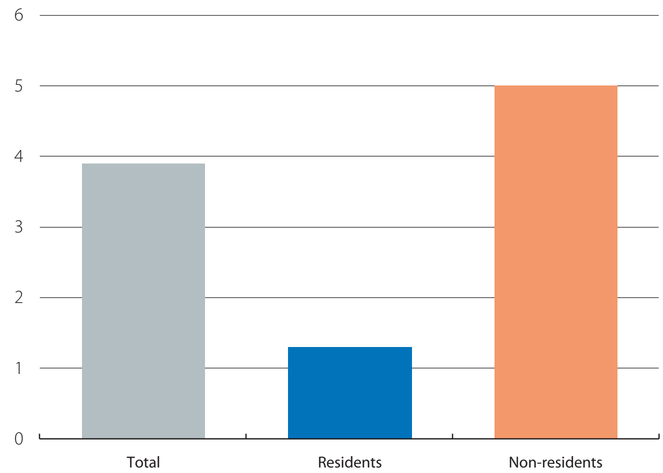
Millions of euros



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

Evolution of overnight stays in tourism

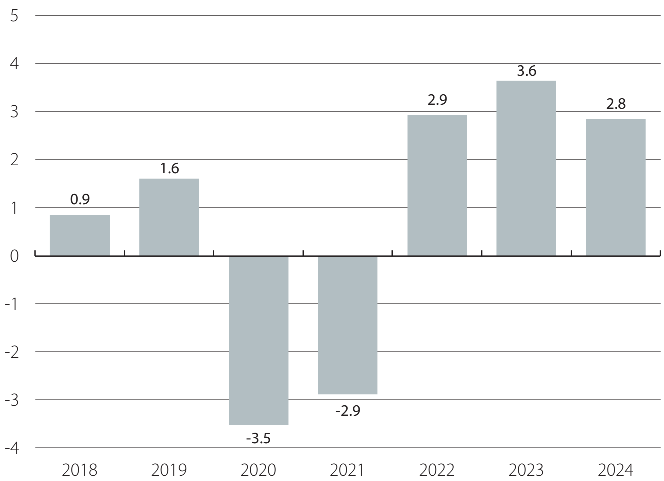
YTD September 2024 YoY change (%)



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

Budget balance (Public Accounting)

Budget balance in the first 9 months of the year (% of GDP)



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

The budget is balanced, but the risks continue to lurk

The delivery of the State Budget Proposal is the highlight of October. This year has become especially relevant because, in addition to the external risks that have dominated our narrative in recent years (especially geopolitical in nature), it brings with it another source of uncertainty, associated with the absence of an absolute majority of the parties that support the current government in Parliament.

First of all, it should be noted that the macroeconomic scenario underlying the 2025 State Budget Proposal (POGE 2025) is broadly in line with the forecasts of other institutions, including our own. Even so, some components of GDP show different dynamics, such as investment (stronger in 2024 and less dynamic in 2025, apparently underpinned by the expectation of a good performance in 2H 2024), and also the evolution of inflation, which the government projects to slow down, leading to a more robust nominal GDP in the official projections.

Where do we start from?

We are starting from a year, 2024, that should end with a better-than-expected surplus in its State Budget, as has been customary. The Executive slightly revised the budget surplus for 2024 upwards from 0.2% to 0.4% of GDP, with both sides of the balance (revenue and expenditure) ending 2024 higher than initially forecast.

Revenue was revised upwards by around €2 billion (i.e. around 0.7% of GDP), mainly due to social security contributions (+€1.7 billion, 0.6% of GDP). The main justification lies in the behaviour of the labour market, with the employed population and salaries growing more than estimated in the 2024 State Budget; more specifically, 1.4% on average in the first half of the year (compared to 0.4% forecast in the 2024 State Budget) in the first case and more than 6% in the second (compared to 5% forecast).[1]

At the same time, expenditure is expected to be 1.6 billion euros (0.6% of GDP) higher, in this case as a result of higher spending on social benefits (namely the extraordinary payment to the lowest pensions in October) and on personnel costs (given the revisions made to some Public Administration careers).This upward revision is offset by the opposite adjustment in the interest item (by –440 million euros).

Even so, and based on the 1H budget execution and the measures that have since come to light (such as the revision of the personal income tax brackets or the career review), it is possible that the year will end with a budget surplus closer to 0.6% of GDP than the 0.4% estimated by the government.

Where are we going?

The POGE 2025 shows a drop in the budget surplus to 0.3% of GDP, with expenditure growth outstripping that of revenue, with fiscal policy taking on a slightly expansionary character in 2025.

Macroeconomic Scenario in Portugal

Year		2024			2025		
Institution / Publication date	2023	BdP Other 24	MF Other 24	BPI Sep. 24	BdP Other 25	MF Other 25	BPI Sep. 25
Actual GDP	2.3	1.6	1.8	1.7	2.1	2.1	2.3
Private Consumption	1.6	2.5	1.8	2.2	2.3	2.0	1.7
Public Consumption	1.0	1.0	2.6	1.0	0.9	1.2	0.8
Investment	2.6	0.8	3.2	1.3	5.4	3.5	5.7
Exports	4.1	3.8	2.5	4.2	3.3	3.5	5.0
Imports	2.2	4.5	2.9	4.6	4.4	3.5	5.0
Nominal GDP	9.6	–	5.0	4.3	–	4.8	4.5
HICP *	5.3	2.6	2.6	2.4	2.0	2.3	2.1
Unemployment rate	6.5	6.5	6.6	6.5	6.4	6.5	6.4
Employment	0.9	1.1	1.1	0.9	0.6	0.7	1.3
Current Scale	1.3	–	0.9	1.2	–	0.7	1.4
Capital Balance	1.3	–	2.5	1.5	–	2.8	1.7

Note: ** CPI for BPI forecasts.*
Source: *BPI Research, based on data from INE, POGE 2025 and Boletim Económico (October 2024).*

1. According to the perspective of the national accounts.

Main items in the public accounts
(% GDP)

	2019	2023	2024	2025	Variation 2025-2019	Variation 2025-2024	
					% GDP	YOY%	Contributions
Current revenue	42.2	42.5	43.2	43.4	1.1	5.1	4.9
Tax and contributory revenue	36.6	37.4	37.7	37.5	1.0	4.2	3.6
Capital income	0.4	1.2	1.5	2.1	1.7	44.0	1.5
Total revenue	**42.6**	**43.6**	**44.8**	**45.5**	**2.9**	**6.4**	–
Intermediate consumption	5.1	5.2	5.4	5.5	0.4	5.8	0.7
Personnel expenses	10.8	10.4	10.8	10.9	0.1	5.6	1.4
Social benefits	18.2	17.5	18.3	18.1	0.0	4.0	1.6
Interest	2.9	2.1	2.1	2.2	-0.7	10.4	0.5
Subsidies	0.4	0.8	0.8	0.7	0.2	–12.3	–0.2
Investment	1.9	2.6	3.3	3.7	1.9	16.7	1.3
Total expenditure	**42.5**	**42.4**	**44.4**	**45.2**	**2.7**	**6.6**	–
Primary current expenditure *	**36.7**	**36.4**	**38.1**	**38.1**	**1.4**	**4.9**	**4.2**
Overall Balance	**0.1**	**1.2**	**0.4**	**0.3**	**0.2**	–	–
Primary balance	**3.0**	**3.3**	**2.5**	**2.5**	**–0.5**	–	–
Primary structural balance	**2.0**	**3.1**	**2.3**	**2.2**	**0.2**	–	–
Public debt	**116.1**	**97.9**	**95.9**	**93.3**	**–22.8**	–	–

Source: *BPI Research, based on data from INE, GSB 2025 Proposal and AMECO.*

The 6.4% increase in revenue (around 8,000 million euros) is more than half explained by the increase in tax and social security revenue. In fact, despite fiscal policy measures with a negative impact of more than 1.4 billion euros (around 0.5% of GDP), including, for example, the extension of the youth personal income tax and the reduction in VAT on electricity, tax and social security revenue is expected to increase by 4.2% (around 4.5 billion euros). In addition to the positive effect of economic growth, higher employment and wages, the positive evolution of this item is also explained by the reinstatement of fuel taxes (with an impact of 650 million euros, 0.2% of GDP). In this context, direct taxes are expected to fall by 0.6 p.p. to 10.0% of GDP, only partially offset by an increase in indirect taxes (+0.2 p.p. to 14.7%), reducing the tax burden by 0.2 p.p. to 37.5% of GDP. However, assuming the historical relationship between nominal GDP and tax and contributory revenue (the elasticities) and adjusted for these budgetary measures, it is possible that this item is overestimated by around 0.1% GDP. If confirmed, the increase in tax and social security contribution revenue would be around 3.9%, instead of the 4.2% projected in POGE 2025.

Another important part of the increase in revenue is the PRR component, which explains around 40% of the expected increase in revenue for next year (i.e. around 3.1 billion euros). If we exclude this share (of around 2.3% of GDP), total revenue would increase by around 4%, i.e. slightly below 5 billion euros.

On the expenditure side, the projected increase for next year (of 6.6% or around 8.3 billion euros) is explained by more than 60% by three items: in this order, social benefits, personnel expenses and investment.

More than half the increase in social benefits is explained by the updating of pensions according to the formula laid down by law and the increase in the number of pensioners, a total impact of 1.6 billion euros (0.4% of GDP). Added to this is the reinforcement of the Solidarity Supplement for the Elderly (120 million euros) and other smaller measures. There is also the possibility of an extraordinary payment to the lowest pensions in October 2025, as happened this year, but this will depend on the good progress of the public accounts and the decision on which will only be made in the summer of next year.

In turn, personnel costs reflect the salary increase for civil servants (of 52.63 euros or a minimum of 2%), with an impact of almost 600 million euros, to which are added other measures such as progressions, promotions, updating the minimum wage for the Civil Service (from 821.83 euros to 875 euros), recovery of teachers' length of service and other career reviews already agreed this year.

Finally, in terms of investment, an increase of 16.7% is expected (around 1.6 billion euros), which, if confirmed, would place its weight in GDP (3.7%) at the highest level since 2010. The big doubt relates to the capacity to execute this item, which, it should be remembered, has typically been lower than budgeted in recent years.[2] Even so, we believe that the intention to increase public investment in 2025 seems more credible, given the need to speed up the execution of EU funds, especially the RRP, in line with the historical time execution curve of this type of instrument. In fact, more than 60% of the increase in public investment is explained by the impact of the PRR, so if we exclude this effect, public investment would stand at around half. In total, if we exclude the effect of the RRP from revenue and expenditure, the budget balance would go from 0.5% of GDP in 2024 to 0.7% in 2025.

Lastly, the Ministry of Finance points to a rise in interest charges for the third year running (+10.4%), from 2.1% of GDP in 2024 to 2.2% in 2025, although this is still lower than in 2019 (2.9%). This evolution reflects the worsening cost of the debt issued more recently.[3] The Executive's estimate seems adjusted to the context, and even in a more extreme scenario, in which interest rates on 10-year OTs reached 7% (levels recorded at the beginning of 2011 and highly unlikely at the moment), the interest burden would be around 3% of GDP. Thus, and assuming, in a very simplistic way, that no other items would change, the budget balance would reach a deficit of around 0.5% of GDP.

Overall, the budgetary policy measures should contribute to an increase in expenditure of more than 1.7 billion euros (around 0.6% of GDP), of which more than 90% relates to personnel costs.[4] In this context, current primary expenditure will remain at high levels (38.1% of GDP, as in 2024), which, if we compare to the pre-pandemic period, corresponds to an increase of 1.4 p. p. of GDP.[5] This development is particularly worrying due to the more rigid nature of this expenditure (it excludes public investment and interest paid on public debt, which the state does not control), i.e. it is the most difficult expenditure to reverse should a negative shock materialise. However, it should be borne in mind that this item is also influenced by the implementation of the RRP: without these funds, current primary expenditure would have increased by 0.6 p. p. compared to the pre-pandemic period.

In this context, the public debt ratio will continue its downward trajectory: according to the government, it should fall from 95.9% of GDP in 2024 to 93.3% in 2025, a drop explained more than half by the growth in economic activity. Government forecasts indicate that it will be possible to reach a public debt ratio of around 65% in 2038.

The prospect of a continued drop in public debt levels, along with the commitment to balancing public accounts, is particularly important for the country, given that Portugal is still among the 20 countries with the highest public debt ratios in the world. This stance should help sustain the risk premium below the other peripherals and could also support an improvement in the Republic's rating. However, risks still lurk: the main focus continues to be on the external front, namely geopolitical risks (and the impact they may have on the price of raw materials, especially oil) or fluctuations in the financial markets. On the domestic front, we would also highlight the fragmentation of Parliament and the possible pressure on public accounts resulting from the approval of measures that could increase spending. Likewise, the weak implementation of the RRP continues to constitute a relevant risk. Even so, upward risks can also have a positive impact on budget execution, particularly greater household consumption, in a context of reduced loan burdens and increased disposable income.

Vânia Duarte

2. The exception could be 2024, which, if the government's estimate is confirmed, could be around 150 million euros higher than projected in the 2024 State Budget.
3. The cost of the new debt increased from 1.7% in 2022 to 3.5% in 2023 and reaches 3.4% in 2024. In this context, the cost of debt stock increased by 0.3 pp in 2023, to 2.0%.
4. This estimate does not include the recent upward revision of the civil service minimum wage, which was initially set at 870.50 euros and, in negotiations with the unions after the publication of the POGE 2025, was set at 875 euros.
5. The increase of around 42% in current primary expenditure compared to 2019 is explained, by around 70%, by the increase in social benefits (with an increase of around 37%, or +14,350 million euros) and personnel costs (+38%, +8,870 million euros).

Housing Price Index: upward revision

On average, house prices (as measured by INE's HPI) increased by 12.6% in 2022 and 8.2% in 2023 (8.7% for existing properties and 6.6% for new properties). BPI Research's forecast pointed to an average appreciation of 4.3% in 2024, but following the publication of the 2Q 2024 HPI data and other factors already known, it became imperative to revise this figure upwards.[1] We explain the rationale behind the revision here.

In fact, the 2Q 2024 figure was very strong - a quarterly rise of 3.9% - the highest in this series. We need to go back to Q1 2022 to find a quarterly variation of this order (3.8%, in this case). In year-on-year terms, the price increase was 7.8%, which is still consistent (albeit on a smaller scale) with the vision of a slowdown in the market compared to 2023 that we had anticipated. The figure was also strong in terms of the number of transactions (37,125), mainly because it interrupted seven quarters of significant year-on-year falls (in 2023 sales fell by almost 19%). In fact, transactions in Q2 2024 increased by 12% quarter-on-quarter and 10% year-on-year. With this data, we have also stopped projecting a residual drop in the number of transactions compared to 2023, now expecting them to increase by an average of around 5%.

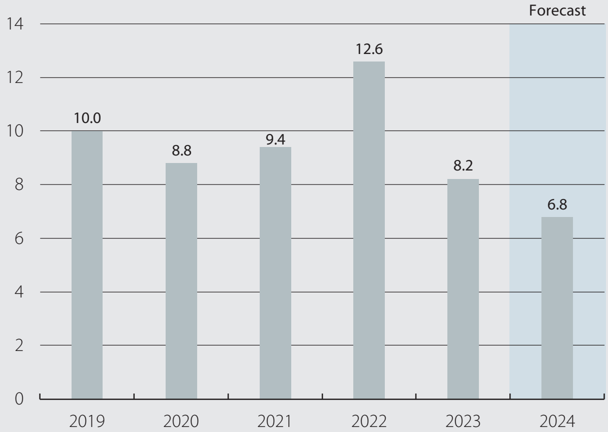
What reasons can explain this behaviour? Essentially, there are two aspects to which we attach the greatest importance.

Firstly, the disinflationary process in the eurozone after Q1 2024 was already looking more consistent. In May, for example, both overall inflation and underlying inflation in the eurozone were below 3% and there was already a strong belief in the markets that the ECB would cut its benchmark rates for the first time in June, which it did. The effect of this is manifold. On the one hand, the prospect of lower financial charges brings optimism to those who want to buy, anticipating less pressure on the family budget. Lower interest rates translate into lower debt servicing and a better framework for the metrics used to analyse the risk of mortgage loans, such as the effort rate. Finally, in financial terms, lower interest rates typically mean higher asset prices.

Secondly, we consider that the Government's announcement of measures to impact the housing market also had an influence. Here, we attach special relevance to the measure of exemption from IMT on the acquisition of permanent housing by people under 35 years of age. Real estate market operators indicate that some buyers (over 35), in anticipation of this measure, which would only come into force in August, have positioned themselves in anticipation of an increase in demand for properties from young people.

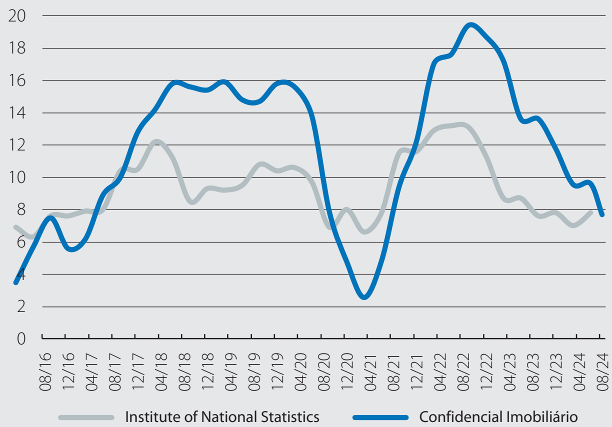
1. Specifically, we are now looking at an average change in the HPI in 2024 of 6.8%.

Housing Price Index
Average annual variation (%)



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

Housing/residential price index
Y-o-Y Var. (%)



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

In the remaining quarters of the year, house prices should continue to rise, although less strongly than in this second quarter. Overall, the context is one of factors that support the market. The positive migratory balance (via immigration) should continue to contribute to the growth of the active population and the acquisition of property by non-residents in greater numbers than before the pandemic should continue. The resilience of demand with continued low levels of unemployment and rising real wages, combined with a supply that is not skyrocketing.[2] Finally, the continued and convinced

2. By Q2 2024, new housing units completed amount to 12,193. If the pace of construction remains the same as in the first half of the year, new homes built should increase by 3% compared to 2023.
3. Real estate agents and promoters.

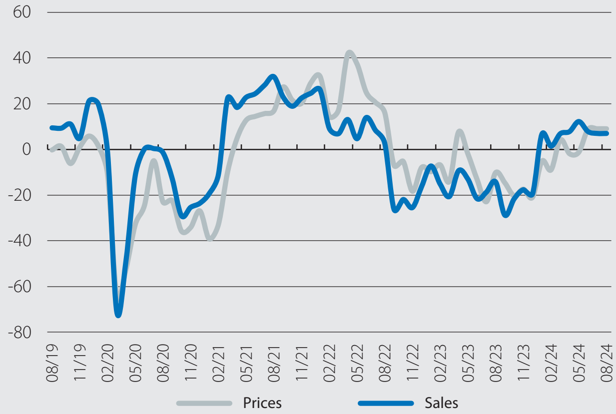
progression of the monetary easing process - at the September meeting the Governing Council's decision to cut the *deposit* interest rate by 25 bp was taken unanimously.

Apart from this, the known figures after Q2 2024 are also positive. In August, the sales and price expectations for the next 3 months among market agents Survey[4] have simultaneously been in positive territory for three consecutive months. Data from the Residential Price Index, also produced by Confidencial Imobiliário, show an increase in prices in July and August (monthly growths of +0.1% and +0.9%, respectively). The median value of the bank appraisals of real estate within the scope of mortgage credit processes also advanced in July and August (+7.4% and 8.2% year-on-year, respectively).

Finally, we must point out that not everything is positive on the risk horizon and some aspects are contributing to a slowdown in the market. Namely, the slowdown of the national economy and modest growth of the Eurozone economy; and the growing gap between wage growth and property price growth.

Tiago Belejo Correia

Three-month price and sales expectations
Balance of extreme responses



Source: *BPI Research, based on data from Confidencial Imobiliário.*

4. Prepared by Confidencial Imobiliário.

The «Traffic Light of Activity»

Monitoring national economic activity in real time is a *leitmotif* of BPI's economic and financial studies area. Close monitoring of everything related to activity and growth will allow us to build scenarios more efficiently and contribute to the understanding of the economic reality by those who follow our publications.

Thus, one of the major challenges is forecasting the macroeconomic variable that is the benchmark for defining the size and growth of an economy – Gross Domestic Product (GDP). However, GDP data is released on a quarterly basis and usually about a month after the end of the quarter to which it refers. Ideally, our vision must be more timely, with a view to providing *inputs* at all times about the economy and providing the best outlook for the current quarter (and subsequent ones).

There are, however, indicators of various kinds that are released more frequently and can be linked to the progress of economic activity. We have developed a tool – the «Activity Traffic Light» – which aims to take a selection of indicators (with a frequency greater than quarterly) and relate them to GDP. We present it in the following paragraphs.

Choosing indicators and building the «Activity Traffic Light» tool

We started from a broad *pool* of candidate indicators to be part of the «Traffic Light» and the spirit behind choosing them was based on two criteria. First, they must have a high frequency (weekly or monthly). Second, they are potential *proxies* for broad coverage of economic activity in its various aspects and sectors – private consumption, tourism, and industrial activity, for example. Finally, we also sought to combine *hard data* (quantitative data based on objective and measurable information) with *soft data* (data of a more qualitative nature and reflecting opinions, perceptions or expectations). Hard data can be expected to better reflect the current situation, while *soft data* can better capture future trends.

Ten indicators from the *pool* were selected: Daily activity indicator (DEI); Employment (number of employed population); production index in Construction and Public Works; retail trade turnover index; industry turnover index; services turnover index; ISE (economic sentiment indicator); ATM purchases by non-residents (value of purchases with cards issued abroad at ATMs in Portugal), ATM (deflated value of withdrawals and purchases with ATM cards); Non-resident tourists (number of non-resident guests in national tourist accommodation establishments).

In order to decide which variables to include in the «Traffic Light», we began by checking which ones had the highest correlation with changes in GDP. We present the correlation matrix in the first figure. The diagonal represents the correlation of the variable with itself, but in the first column we can see the correlation coefficient of GDP with each of the variables in the *pool*.

As can be seen from the matrix, all indicators have a medium or high/very high correlation with GDP. The Services turnover index was the indicator with the highest correlation (0.965) and the ATM (withdrawals and purchases with cards) the one with the lowest correlation (0.652). We first selected the indicators with a correlation above 0.95 (ISE, DEI and Services Turnover Index) and then those with a correlation above 0.90 (Commerce Turnover Index and Prod. Construction Index), eventually «dropping» the Construction Prod.

Correlation matrix between variation in indicators and variation in GDP

	GDP	DEI	Employment	Construction_ production_ index	Commerce_ turnover_ index	Industry_tur-nover_index	Services_tur-nover_index	ISE	ATM_purcha-ses_not_resi-dent	ATM_with drawals_ and_purcha-ses	Tourists_ non_resi-dent
GDP	1.000	0.962	0.677	0.906	0.904	0.848	0.965	0.950	0.690	0.652	0.719
DEI	0.962	1.000	0.628	0.898	0.871	0.859	0.939	0.974	0.673	0.597	0.719
Employment	0.677	0.628	1.000	0.567	0.711	0.494	0.692	0.603	0.458	0.608	0.214
Construction_production_index	0.906	0.898	0.567	1.000	0.756	0.763	0.853	0.862	0.579	0.525	0.628
Commerce_turnover_index	0.904	0.871	0.711	0.756	1.000	0.764	0.916	0.891	0.713	0.762	0.705
Industry_turnover_index	0.848	0.859	0.494	0.763	0.764	1.000	0.877	0.823	0.498	0.474	0.598
Services_turnover_index	0.965	0.939	0.692	0.853	0.916	0.877	1.000	0.930	0.699	0.670	0.681
ISE	0.950	0.974	0.603	0.862	0.891	0.823	0.930	1.000	0.710	0.616	0.776
ATM_purchases_not_resident	0.690	0.673	0.458	0.579	0.713	0.498	0.699	0.710	1.000	0.885	0.864
Mb_withdrawals_and_purcha-ses	0.652	0.597	0.608	0.525	0.762	0.474	0.670	0.616	0.885	1.000	0.679
Tourists_non_resident	0.719	0.719	0.214	0.628	0.705	0.598	0.681	0.776	0.864	0.679	1.000

Highest correlation   Lowest correlation

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

Index and replacing it with the Industry Turnover Index (0.848) so that we could also have a view by major sector groups – Industry, Trade and Services.

After removing *outliers*, we standardised the series so that the quarterly (and monthly) records varied between –1 and 1, facilitating comparability, and established six performance brackets based on percentiles – Extreme weakness, Weakness, *Steady «downside», Steady «upside»*, Strength and Extreme strength. This way, every time an indicator is published, we can automatically assess its relative performance and place it in a performance bracket. By weighting each of the five indicators with a weight of 20% for the «Traffic Light» we can finally construct it. This retrospective exercise is presented in the second image.

As we can see, the 2008 financial crisis,[1] the sovereign debt crisis with the entry of the «troika» into the country in 2011[2] and the Covid health crisis are clearly highlighted in the graph as periods of weakness and extreme weakness.[3] On the other hand, the «Traffic Light» also points to 2Q 2021 and 4Q 2021 as periods of extreme strength in activity, when GDP advanced in quarterly terms by +4.5% and +1.9%, respectively. These signals seem to show that the indicator performs well in signalling periods of expansion and recession.

What is the traffic light signaling?

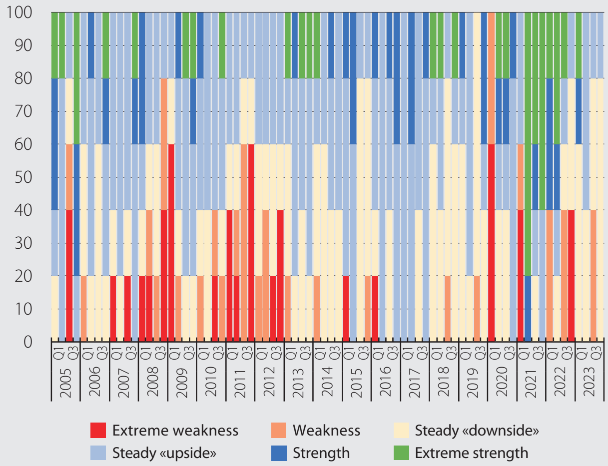
Looking ahead to 2024, we carried out the exercise of establishing the midpoints of each of the equivalent performance brackets for GDP variations and weighting them by the «Traffic Light» percentages. With this, we can see that the quarterly change in GDP that the «Traffic Light» pointed to for Q1 2024 was 0.51% and it was 0.64% that was confirmed with the publication of the data. In Q2, the «traffic light» pointed to 0.26% and the actual figure was lower than that (0.21%), and finally, in Q3 it pointed to 0.29% and the actual figure was also lower (0.2% in the quick estimate). At the time of writing, of course, there is still no published data for Q4 2024 GDP, the quarter is still underway, and in the «Traffic Light» some indicators only have data up to September. However, with the current data, the «Traffic Light» points to a quarterly change in GDP of 0.41% in Q4 2024, which is lower than BPI Research's forecast (0.60%). This exercise is illustrated in the last image.

We presented how this new tool works, which may appear in future BPI Research publications and analyses. Of course, it is not the «Holy Grail», and additional calibrations or other adjustments that may be required are not ruled out. This is just one more contribution to the interpretation of reality at any given moment and could have some *early warning* potential.

Tiago Belejo Correia

1. Remember that the bankruptcy of Lehman Brothers on 15 September 2008 marked the beginning of this period. In the last quarter of that year, 80% of the traffic light indicators pointed to weakness and extreme weakness and the quarterly GDP in Q4 2008 was –1.3%.
2. The Memorandum of Understanding with the «troika» was signed in May 2011 and in Q1 of that year the «traffic light» was already pointing to 60% of the indicators in extreme weakness, with GDP recording a quarterly change of –0.7%.
3. Recall the state of emergency in Q1 2020 and a state of emergency in Q1 2021 (when on 18 January Portugal was the country in the world with the highest number of new cases of infection per million inhabitants). In these periods, 80% and 60% of the «Traffic Light» indicators, respectively, signaled extreme weakness/debilitation and quarterly GDP fell by –4.4% and –2.4%.

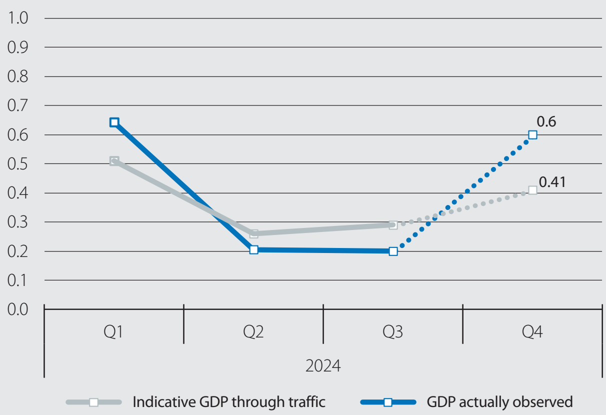
Traffic Light Activity (qoq)



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

GDP

Quarterly variation (%)



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

Activity and employment indicators

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

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Coincident economic activity index	5.7	3.3	2.6	2.0	1.4	...	0.9	...	...
Industry									
Industrial production index	0.8	–3.1	–3.5	1.4	1.4	...	–1.5	2.7	...
Confidence indicator in industry *(value)*	–3.4	–7.4	–9.3	–7.9	–6.7	–6.2	–6.5	–5.5	–4.1
Construction									
Building permits - new housing (number of homes)	6.2	7.5	4.9	–19.6	6.1	...	...	...	...
House sales	1.3	–18.7	–11.4	–4.1	10.4	...	–	–	–
House prices *(euro / m² - valuation)*	13.8	9.1	6.4	5.5	6.8	...	8.2	10.0	...
Services									
Foreign tourists *(cumulative over 12 months)*	158.9	19.1	19.1	13.1	9.5	...	8.8	7.7	...
Confidence indicator in services *(value)*	15.2	7.6	1.7	6.3	4.3	–0.4	–1.6	0.8	5.5
Consumption									
Retail sales	5.5	1.1	0.6	1.8	2.2	...	5.6	5.0	...
Coincident indicator for private consumption	3.9	2.4	2.2	1.7	1.5	...	1.7	...	...
Consumer confidence index *(value)*	–29.7	–28.6	–27.2	–24.6	–18.7	–14.3	–14.3	–13.1	–13.9
Labour market									
Employment	3.3	2.3	2.3	1.4	1.0	...	1.4	1.6	...
Unemployment rate (% *labour force*)	6.1	6.5	6.6	6.8	6.1	...	6.4	6.4	...
GDP	**7.0**	**2.5**	**2.1**	**1.4**	**1.6**	**1.9**	–	–	–

Prices

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

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
General	7.8	4.4	1.7	2.2	2.7	2.2	1.9	2.1	2.3
Core	5.6	5.1	3.0	2.3	2.4	2.5	2.4	2.8	2.6

Foreign sector

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

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	23.2	–1.4	–1.4	–5.5	–3.7	...	–0.3	...	...
Imports *(year-on-year change, cumulative over 12 months)*	31.7	–4.0	–4.0	–7.3	–5.6	...	–2.3	...	...
Current balance	**–2.8**	**3.6**	**3.6**	**5.1**	**5.8**	**...**	**4.4**	**...**	**...**
Goods and services	–4.7	3.3	3.3	4.6	5.3	...	5.1	...	...
Primary and secondary income	1.9	0.4	0.4	0.5	0.6	...	–0.7	...	...
Net lending (+) / borrowing (–) capacity	**–0.5**	**7.2**	**7.2**	**8.8**	**9.2**	**...**	**7.9**	**...**	**...**

Credit and deposits in non-financial sectors

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

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Deposits [1]									
Household and company deposits	6.4	–2.3	–2.3	2.7	5.6	...	5.8	6.0	...
Sight and savings	7.3	–14.8	–14.8	–11.2	–4.6	...	–7.5	–6.7	...
Term and notice	5.2	14.8	14.8	20.2	17.7	...	22.5	21.0	...
General government deposits	12.4	–12.4	–12.4	9.1	4.5	...	10.2	29.1	...
TOTAL	**6.5**	**–2.6**	**–2.6**	**2.9**	**5.6**	**...**	**6.0**	**6.7**	**...**
Outstanding balance of credit [1]									
Private sector	1.7	–1.5	–1.5	–0.8	–0.3	...	0.5	0.9	...
Non-financial firms	–0.6	–2.1	–2.1	–1.7	–1.7	...	–1.2	–1.2	...
Households - housing	3.2	–1.5	–1.5	–0.8	0.0	...	1.0	1.5	...
Households - other purposes	2.9	0.2	0.2	2.0	2.7	...	3.5	4.4	...
General government	–2.7	–5.5	–5.5	5.9	–5.8	...	–3.4	–4.1	...
TOTAL	**1.6**	**–1.6**	**–1.6**	**–0.5**	**–0.5**	**...**	**0.4**	**0.8**	**...**
NPL ratio *(%)* [2]	**3.0**	**2.7**	**2.7**	**2.7**	**2.6**	**...**	–	–	–

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

The Spanish economy confirms the good tone in Q3

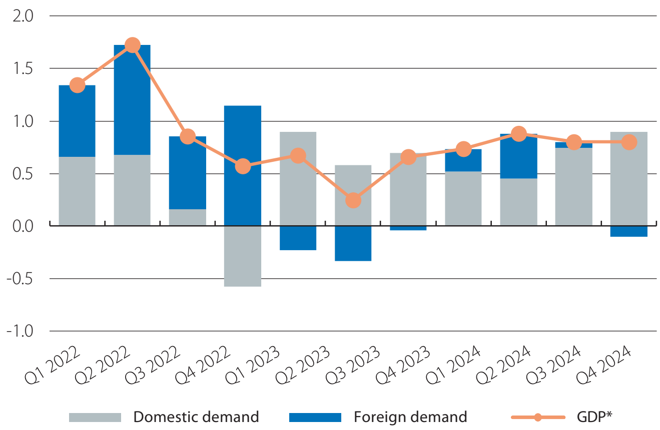
GDP growth once again beat expectations in Q3. Specifically, GDP grew by 0.8% quarter-on-quarter, the same rate as in Q2 2024, and substantially above both the euro area average (0.4% quarter-on-quarter) and our forecast. In year-on-year terms, the growth rate accelerated to 3.4% from 3.2% in the previous quarter. This better-than-expected GDP growth figure for Q3 2024 introduces upside risks to our GDP growth forecast for 2024 as a whole, which is currently 2.8%. Following this advance, the Spanish economy stands 6.6% above pre-pandemic levels, compared to a 4.6% increase in the euro area.

GDP growth was driven by private and public consumption, while foreign demand became less relevant and investment failed to take off. In particular, private consumption posted a quarter-on-quarter growth rate of 1.1%, outpacing GDP, in line with the previous quarter. On the other hand, investment disappointed with a quarter-on-quarter decline of 0.9%. This was a result of the stagnation in capital investment, weighed down by the 4.2% quarter-on-quarter contraction in investment in transport, as well as by the fall in construction investment of 1.7% quarter-on-quarter. Public consumption, meanwhile, served as an important supporting factor, recording quarter-on-quarter growth of 2.2%, 1.6 pps above the figure for Q2. This growth in public consumption was higher than expected and largely explains the gap versus our forecast. Finally, foreign demand subtracted 10 basis points from quarter-on-quarter GDP growth. This was due to the fact that the increase in exports, which was a significant 0.9% quarter-on-quarter, fell short of the 1.2% growth in imports, driven by domestic demand.

The labour market and the PMIs kick off Q4 on a good footing. In the labour market, job creation is gaining momentum and social security affiliation grew in October by 134,307 workers compared to the previous month – a rate of 0.63% – driven mostly by the services sector. This increase was much greater than usual for a month of October: both last year and in the average of that month during the period 2014-2019, the increase was 0.45%. The total number of registered workers has thus risen to 21.33 million workers, which is 514,856 more than a year ago. In seasonally adjusted terms, employment posted a monthly increase of 67,772 registered workers, which is the biggest increase since March and well above the monthly average for Q3 (+18,000). Meanwhile, the sentiment indicators continue to show dynamism after finishing Q3 on a strong note, especially in the case of manufacturing: in October, the PMI for this sector stood at 54.5 points, well within expansive territory (above the 50-point threshold) and surpassing the figure for September (53 points), as well as the average for Q3 (51.5). Finally, the services PMI lost some ground, although it remained well within expansive territory, standing at 54.9 points in October (55.2 on average in Q3 and 57 in September). Leaving these statistics to one side, at the end of October the storm that

Spain: contribution to GDP growth by component

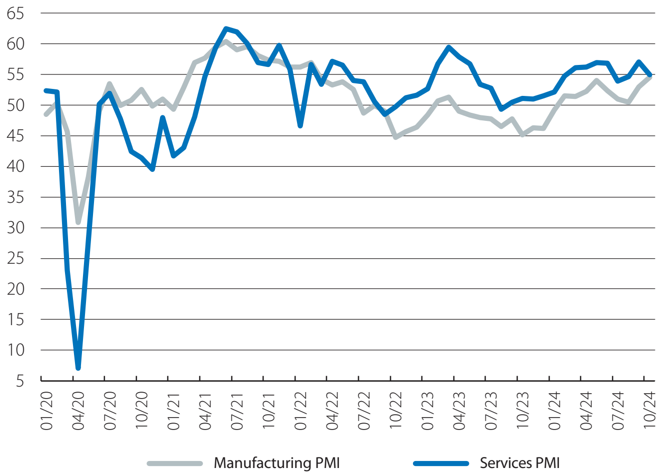
Contribution to the year-on-year change of GDP (pps)



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

Spain: PMI

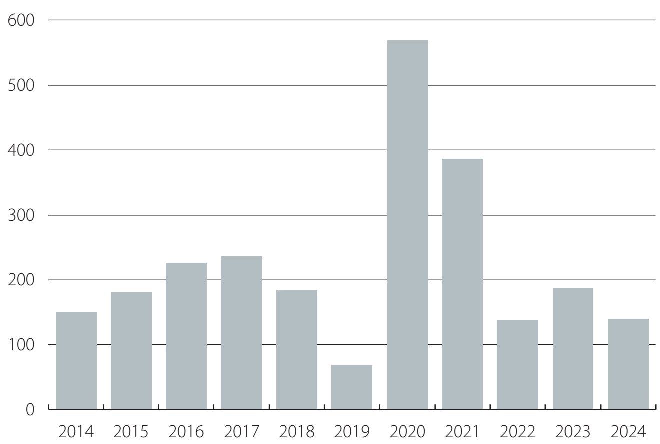
Level



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

Spain: quarterly change in the number of people in employment in Q3 2024

(Thousands)



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

battered much of the province of Valencia caused great human and economic devastation in the area. The destruction caused by the cold drop will take a toll on GDP growth in Q4, and although limited at the aggregate level, the impact will be significant in the affected area.

Employment performed well in Q3. The Labour Force Survey confirmed that the Spanish economy continued to create jobs at a steady pace in Q3, with seasonally adjusted growth of 0.4% quarter-on-quarter, the same rate as in the previous quarter. In addition, unemployment fell by 1,200 people in Q3 2024, compared to an increase of 86,000 in the same quarter of 2023. Thus, the unemployment rate dropped to 11.2% from the 11.3% it stood at in Q2 2024, 0.7 pps lower than the rate of a year ago (11.9%).

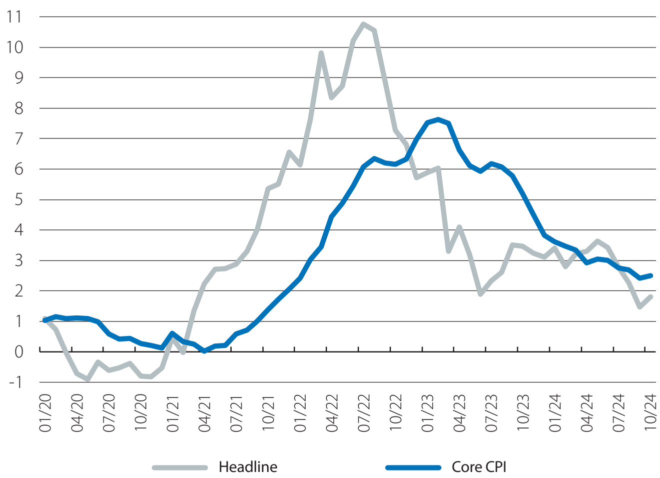
Also of note is the moderation in the growth rate of the labour force, which has gone from a year-on-year rate of 1.6% in Q2 to 1.0%, the smallest increase since Q3 2022. This slowdown comes from both Spaniards and foreigners, although the latter continue to grow at a much faster rate than the former (4.7% year-on-year versus 0.3%, respectively).

Inflation rebounded 0.3 pps to 1.8%, mainly due to higher fuel prices and also, albeit to a lesser extent, to higher electricity and gas prices, which fell in October in 2023. Over the coming months, the likely increase in electricity prices, according to the futures markets, coupled with the second VAT rise on food in December could give some continuity to the upturn in inflation observed this month, although we expect the increase to be moderate in any case.

The tourism sector closed the summer season with excellent records. Hotel overnight stays rose by 3.8% year-on-year in September, driven by international tourists, which grew by 4.7% year-on-year, while those of resident tourists fell by 2.2% year-on-year. This figure is somewhat below the average growth of overnight stays so far this year (5.2%), which is consistent with tourism growth that remains robust but which is stronger in the low season than in the high season, as the seasonality of the sector continues to moderate. It should be noted that the sector continues to break records for the year to date. Indeed, between January and September we received 73.9 million international tourists, some 7.4 million more than in the same period last year.

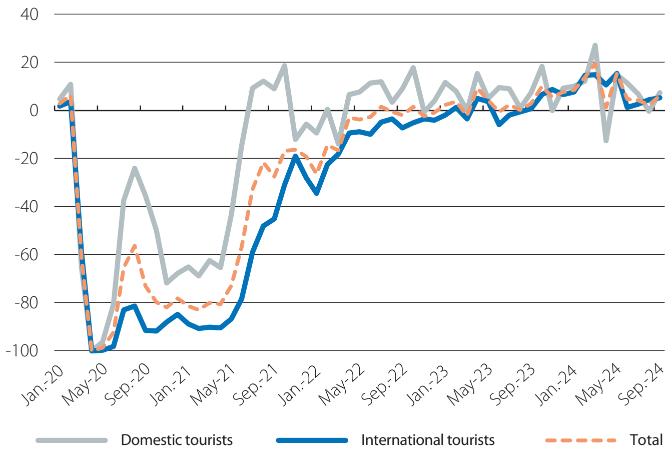
The demand for housing remains strong, while supply shows incipient signs of recovery. The number of sales in the first eight months of the year decreased by 1.0% year-on-year. Despite this slight decline, home sales remain high from a historical perspective (579,000 in the last 12 months, compared to 505,000 in 2019) and new homes are showing particularly strong growth (+7.7% year-on-year in the year to date). The housing supply remains limited and below net household creation, which is applying upward pressure on home prices. The number of new construction licences has increased by 16.4% year-on-year in the first eight months of the year, reaching 121,000 in the last 12 months, and we expect this figure to continue to steadily rise.

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



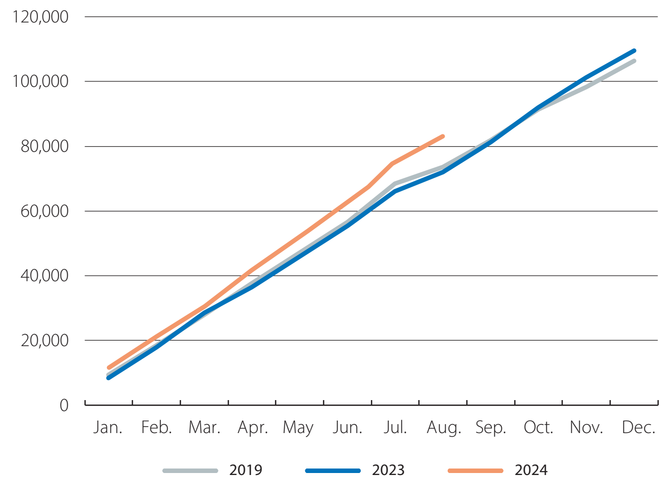
Source: *BPI Research, based on data from the Spanish National Statistics Institute (INE).*

Spain: tourist overnight stays in accommodation establishments
Change versus the same month of 2019 (%)



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

Spain: new housing construction licences
Number (cumulative year to date)



Source: *BPI Research, based on data from the Ministry of Housing and Urban Agenda.*

The Spanish real estate market in 2024-2025: in expansive mode

The current state of Spain's real estate market is characterised, broadly speaking, by the strength of demand and the scarcity of supply. As a result of this mismatch between supply and demand, home prices have accelerated, especially in the case of new-builds. Here at CaixaBank Research we already predicted that the upward trend in the real estate market would take hold in 2024, but the published data have proved to be more bullish than expected, and this, together with the improvement in the economic outlook, has led us to revise upwards our real estate sector forecasts for 2024-2025.

Strength of housing demand

After peaking in 2022 with 650,000 home sales according to the National Statistics Institute (INE), the number of transactions dropped sharply in 2023 (–10 2%) due to the rise in interest rates and the fading of the temporary factors that had driven up the demand for housing in the aftermath of the pandemic. Between January and August 2024, the number of sales has remained practically stable at around 578,000, which is a significant figure from a historical perspective (450,000 on average during the period 2015-2019). By type of housing, a change in pattern is beginning to emerge, with sales of new homes recording rapid growth (+7.7% year-on-year in the eight-month period from January to August) while those of existing homes have declined (–3.1%). That said, new home sales account for just 20.3% of the total (+1.5 pps compared to 2023).

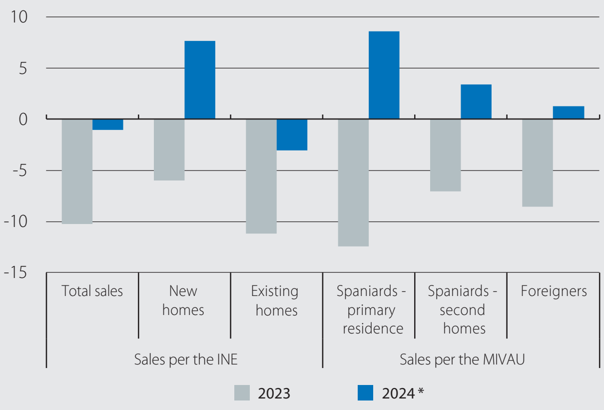
According to type of buyer, sales to Spaniards buying a primary residence grew the most (+8.6% year-on-year in the first half of 2024), after registering a sharp decline in 2023 (–12.4%), reflecting the fact that this category of buyer is the most sensitive to changes in interest rates.[1] On the other hand, the number of sales to foreign buyers, which withstood the increase in financing costs much better, showed the most moderate growth in the first half of 2024 (1.3%), although it remained high from a historical perspective (some 87,600 sales in the trailing four quarters to Q3 2024, representing 14.7% of the total according to the Association of Registrars). Finally, sales to Spanish buyers for second homes grew by 3.4% in the first half of 2024 and represent around 13% of total sales.

Looking ahead to 2025, we expect that the factors supporting housing demand will remain present: net job creation (around 400,000 more people in employment), wage growth above inflation, dynamic migration flows

1. For the breakdown by type of buyer, we use data from the Ministry of Housing and Urban Agenda (MIVAU). We consider a sale to be a second home when the province in which the buyer resides differs from the one where the home is located.

Spain: home sales by type of housing and buyer

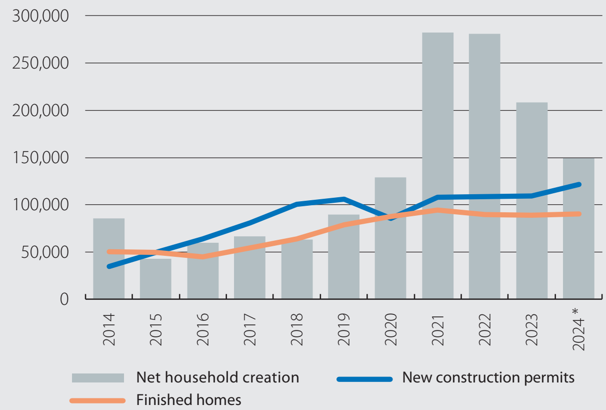
Change (%)



Note: ** Change between the same period in 2023 and 2024, up until the latest available data (INE: August, MIVAU: Q2).*
Source: *BPI Research, based on data from the Spanish National Statistics Institute (INE) and the Ministry of Housing and Urban Agenda (MIVAU).*

Spain: supply of new housing and net household creation

Number



Notes: *The historical data for net household creation come from the Labour Force Survey (LFS) up until 2013, the Continuous Household Survey in 2014-2020, the Continuous Population Survey in 2021-2024.*
** 2024 data correspond to the trailing 12-month period up until the latest available data.*
Source: *BPI Research, based on data from the Ministry of Urban Housing and the Spanish National Statistics Institute (INE).*

(albeit below those of 2022-2023), strong foreign demand, and healthy household finances (household debt represented 45.4% of GDP in Q2 2024, below the euro area average of 52.4%). This is coupled with the easing of financial conditions thanks to the ECB's lowering of interest rates. At its October meeting, the central bank cut interest rates by 25 bps for the third time since June and lowered the depo rate to 3.25%. Following this meeting, the markets assigned a 100% probability to another 25-bp cut in December, while for 2025 market prices pointed to approximately four additional interest rate cuts by the end of that year.

Shortage of supply, but with signs of improvement

The main imbalance in the real estate market today is the lack of housing supply, especially affordable housing. According to the Spanish National Statistics Institute's Continuous Population Statistics, between 2021 and 2023 some 777,000 net households were created (about 260,000 per year), while the number of homes completed in this same three-year period amounted to 273,000 (about 90,000 per year) and the number of new construction permits was about 110,000 per year. It is clear that the number of new homes being built falls far short of demand.

The latest data show that this gap has narrowed (with an increase in net households of around 150,000 up until Q3 2024 according to the Labour Force Survey, compared to some 121,000 new construction permits granted in the 12 month to August). In any case, the gap accumulated in previous years is wide and continues to determine developments in the market. On the other hand, we cannot rule out the possibility that the reduced dynamism in net household creation could be a consequence of the increasing difficulty in affording a home, whether as a buyer or as a renter.

While the major players in Spain's real estate market share this diagnosis, there are multiple factors that are limiting housing production, including the shortage of land earmarked for development, the labour shortage, high construction costs (although the current increases are moderate in year-on-year terms, they are still 30% above 2019 levels) and regulatory changes. It should also be noted that the construction sector has a productivity problem which goes back decades: whereas real GDP per hour worked grew by 19.4% between 1995 and 2023 for the economy as a whole, and by 56.5% for the manufacturing industry, in the case of construction it fell 27.7%.

Home prices in Spain accelerate supported by falling interest rates

The imbalance between housing supply and demand, the improvement in the economic outlook and the decline in interest rates have supported the growth of home prices, which in the first half of 2024 rose by 7.1% year-on-year, according to the Spanish National Statistics Institute. New homes recorded the sharpest price growth (+10.7% year-on-year in the first half of 2024), although existing home prices are also increasing rapidly (+6.5%).

We expect this rally in home prices to continue in 2025, with nominal growth expected to be around 4%, well above inflation. It should be noted that, given the current boom in the real estate market and the good performance of the Spanish economy as a whole, the risks of home prices rising more quickly than anticipated in our baseline scenario are far from negligible. On the contrary, the high prices that have already been reached in certain areas mean that the difficulties people have in affording a home could end up becoming a limiting factor for the growth of demand and prices.

CaixaBank Research forecasts for Spain's real estate sector

	2022	2023	2024	2025
Home prices (INE), change (%)	7.4	4.0	7.1	4.1
Home prices (MIVAU), change (%)	5.0	3.9	5.1	3.6
Sales (thousands)	650	584	572	577
New construction permits (thousands)	109	109	115	125

Source: *BPI Research.*

Finally, it should be noted that the affordability problems associated with the rise in home prices, in both the sales and the rental markets, could end up generating adverse economic and social effects in the medium and long term. Notably, the struggle to afford a home can affect vital decisions and trends such as birth rates, workers' geographical mobility and the accumulation of human capital, among others. On the other hand, there are companies that point to the high cost of housing as a limiting factor for hiring labour in certain sectors and locations. There is no simple solution to this situation, but we hope that the supply of housing in general, and of affordable housing in particular, will gain traction and that this will help to redirect the situation.[2]

2. See the article «The challenge of increasing the supply of affordable housing in Spain» in the *Real Estate Sector Report S2 2024*.

Activity and employment indicators

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

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Industry									
Industrial production index	2.2	–1.1	–0.8	–0.4	0.1	–	–0.1	...	...
Indicator of confidence in industry *(value)*	–0.8	–6.5	–7.9	–5.1	–5.5	–3.0	–3.6	–0.9	–8.1
Manufacturing PMI *(value)*	51.0	48.0	45.9	50.7	52.8	51.5	50.5	53.0	54.5
Construction									
Building permits *(cumulative over 12 months)*	15.4	1.3	0.8	2.9	4.0	–	6.9	...	...
House sales *(cumulative over 12 months)*	29.0	0.1	–9.3	–10.5	–9.6	–	–6.3	...	...
House prices	7.4	4.0	4.2	6.3	7.8	...	...	...	...
Services									
Foreign tourists *(cumulative over 12 months)*	129.8	18.9	18.9	15.8	14.3	12.3	12.8	12.3	...
Services PMI *(value)*	52.5	53.6	51.2	54.3	56.6	55.2	54.6	57.0	54.9
Consumption									
Retail sales[1]	2.3	2.5	2.8	1.1	0.5	2.6	2.4	4.1	...
Car registrations	–3.0	18.5	11.9	4.2	9.6	1.1	–6.5	6.3	7.2
Consumer confidence index *(value)*	–26.5	–19.2	–19.1	–17.2	–14.4	–13.6	–15.0	–12.3	...
Labour market									
Employment[2]	3.6	3.1	3.6	3.0	2.0	1.8	–	–	–
Unemployment rate (% labour force)	13.0	12.2	11.8	12.3	11.3	11.2	–	–	–
Registered as employed with Social Security[3]	3.9	2.7	2.6	2.6	2.4	2.3	2.3	2.3	2.5
GDP	**6.2**	**2.7**	**2.3**	**2.6**	**3.2**	**3.4**	–	–	–

Prices

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

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
General	8.4	3.6	3.3	3.1	3.5	2.2	2.3	1.5	1.8
Core	5.1	6.1	4.5	3.5	3.0	2.6	2.7	2.4	2.5

Foreign sector

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

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Trade of goods									
Exports *(year-on-year change, cumulative over 12 months)*	22.9	–1.4	–1.4	–6.9	–4.9	–	–2.9	...	...
Imports *(year-on-year change, cumulative over 12 months)*	33.4	–7.2	–7.2	–9.8	–7.1	–	–4.6	...	...
Current balance	**4.8**	**39.8**	**39.8**	**41.2**	**45.3**	**–**	**48.3**	**...**	**...**
Goods and services	12.1	58.8	58.8	60.5	65.4	–	68.6	...	...
Primary and secondary income	–7.3	–19.1	–19.1	–19.2	–20.2	–	–20.4	...	...
Net lending (+) / borrowing (–) capacity	**17.5**	**56.0**	**56.0**	**56.0**	**61.4**	**–**	**64.4**	**...**	**...**

Credit and deposits in non-financial sectors[4]

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

	2022	2023	Q4 2023	Q1 2024	Q2 2024	Q3 2024	08/24	09/24	10/24
Deposits									
Household and company deposits	3.1	0.3	0.3	3.3	5.2	4.2	4.8	4.2	...
Demand and notice deposits	3.6	–7.4	–7.4	–5.2	–1.9	–1.7	–1.5	–1.7	...
Time and repo deposits	–3.0	100.5	100.5	96.7	68.0	47.1	52.9	47.1	...
General government deposits[5]	–0.8	0.5	0.5	–4.6	–4.1	14.7	9.4	14.7	...
TOTAL	**2.8**	**0.3**	**0.3**	**2.7**	**4.5**	**5.0**	**5.1**	**5.0**	**...**
Outstanding balance of credit									
Private sector	–0.4	–3.4	–3.4	–2.6	–1.3	–0.3	–0.7	–0.3	...
Non-financial firms	–0.7	–4.7	–4.7	–3.6	–1.8	–0.5	–1.3	–0.5	...
Households - housing	–0.2	–3.2	–3.2	–2.5	–1.5	–0.7	–0.7	–0.7	...
Households - other purposes	0.0	–0.5	–0.5	–0.1	0.7	1.1	0.5	1.1	...
General government	0.6	–3.5	–3.5	–4.8	–2.7	–5.4	–7.5	–5.4	...
TOTAL	**–0.3**	**–3.4**	**–3.4**	**–2.7**	**–1.4**	**–0.7**	**–1.2**	**–0.7**	**...**
NPL ratio (%)[6]	**3.5**	**3.5**	**3.5**	**3.6**	**3.4**	**...**	**3.4**	**...**	**...**

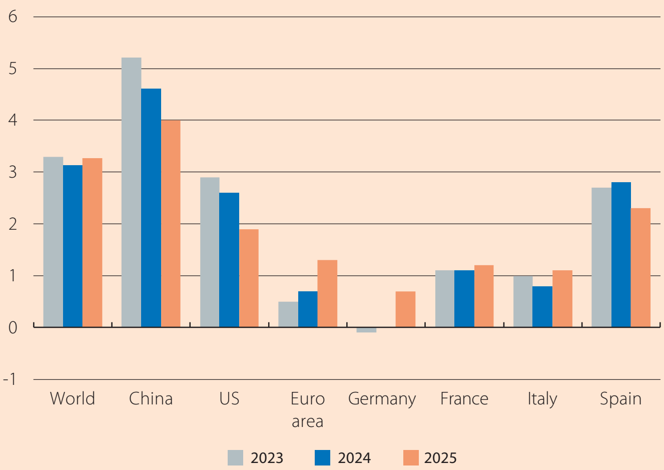
Notes: *1. Deflated, excluding service stations. 2. LFS estimate. 3. Average monthly figures. 4. Aggregate figures for the Spanish banking sector and residents in Spain. 5. Public-sector deposits, excluding repos. 6. Data at the period end.*

Sources: *BPI 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.*

2025 global outlook: in search of a new normal

Five years after the outbreak of the pandemic – the origin of the imbalances and challenges that the international economy has been facing ever since – the feeling (or at least the hope) is that in 2025 we could see a certain degree of normality return to the pattern of the global economic cycle. Such a return to normality – understood as the closing of the gap between supply and demand that has been present in much of the last five years – will allow inflation to converge on the central banks' target rates, and this would lead to an acceleration in the lowering of interest rates towards neutral territory (2% in the euro area and 3% in the US). If we add to the above an oil market which, besides the volatility that geopolitics will continue to transmit, appears to have an equilibrium price in the 70-80-dollar range, we would have a good support base for the consolidation of a soft landing of the world economy.

GDP growth
Annual change (%)

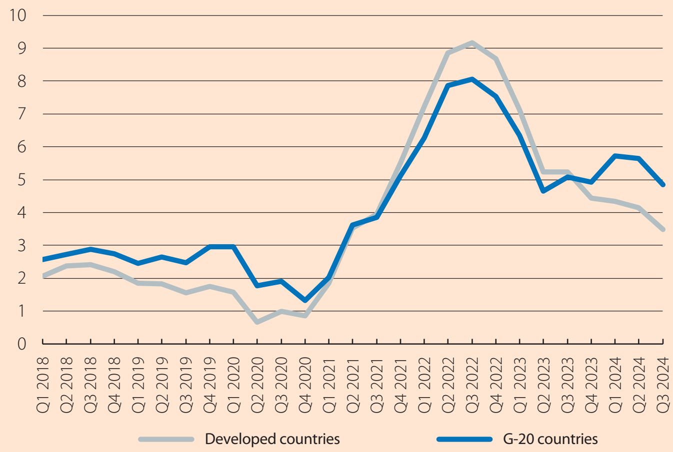


Source: *BPI Research.*

Therefore, it seems that the monetary imbalances caused by the wide variety of shocks that have accumulated in recent years could be on a path to correction, once the surprising and intense inflationary process that was triggered following the pandemic is under control. In this regard, the IMF anticipates that world inflation may fall to 3.5% by the end of 2025 (9.4% in 2022), slightly below the 2000-2020 average (3.6%). Most importantly, the return to price stability is being achieved without having to pay an excessive cost in terms of jobs and economic activity, as the resilient global cycle will maintain a cruising speed slightly above the 3% mark, with most labour markets still generating jobs. The less positive aspect of the macroeconomic outlook is that the recent divergences could become entrenched, both between sectors (the services sector outperforming industry) and between economic areas (the US outperforming the euro area and China) or regions (Germany being the major source of Europe's problems).

Now that the fog of inflation that has been shrouding the business cycle has dissipated, the economic picture once again reveals old problems inherited from the great financial crisis, such as low potential growth, high levels of global public debt (over 100 trillion dollars) and mediocre productivity, especially in Europe. The magnitude of the structural challenges is even greater if we consider that they will need to be addressed in an environment subject to high uncertainty, both because of the underlying rise in geopolitical risk and due to the effects of the process of transforming global trade relations, with supply chains becoming more regional and the world fragmenting once again into different blocs.

World economy: headline inflation
Year-on-year change (%)

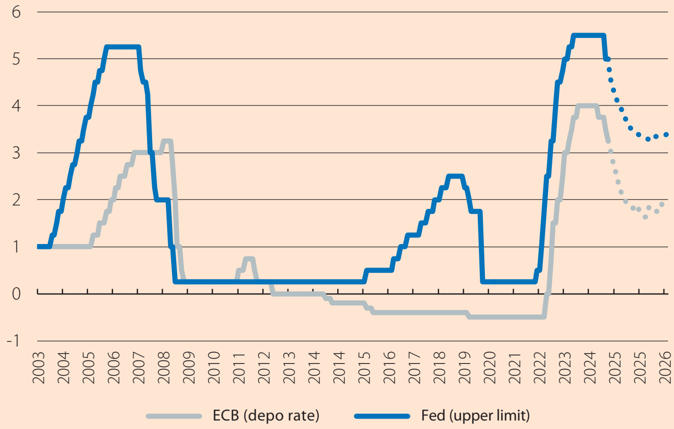


Source: *BPI Research, based on data from Bloomberg.*

In this context, economic policy will have to address these medium- and long-term challenges with a limited degree of freedom on the fiscal side, while digesting the unconventional policies implemented by the central banks and a renewed role of industrial policy. Moreover, all this is taking place while we still have more questions than answers about what happened in the last four years in areas such as the behaviour of inflation expectations, the relationship between employment and prices (a steepening of the Phillips curve) or how supply shocks are distributed between wages and margins. This will make it difficult to anticipate the level at which real interest rates will stabilise or whether inflation will show an asymmetric pattern relative to the target. It will therefore take time for the changes of recent years to be fully digested, but as the IMF has just reflected at its autumn meeting, economic policy will need to pivot towards a triple target: a monetary policy that transitions from restrictive to neutral territory (good news for emerging markets), a fiscal policy that seeks to stabilise the debt dynamics (a particularly challenging task in the US and China) and more decisive supply policies aimed at boosting potential growth. The aim of all this would be to avoid falling into the «middle technology trap» or returning to the risk of «secular stagnation», where low public and private investment coupled with adverse demographic trends could lead to a situation of weak industrial activity, limited innovation and low productivity growth.

Benchmark interest rates

(%)



Note: *The future projections correspond to forward market rates at the close of October 2024.*
Source: *BPI Research, based on data from Bloomberg.*

In this challenging economic and political context, the risk menu is well known to all: intensification of tariff conflicts; escalation of geopolitical risk, with a focus on the Middle East and Ukraine, affecting commodity prices; problems in the last mile of inflation, and increased financial instability. There is also a feeling that Europe and China are at a crossroads for their growth models, as the Draghi plan and the recent economic policy measures announced by the Chinese government have just highlighted. In the case of the Asian country, the economy remains highly vulnerable due to a combination of factors. Besides the problems in the real estate sector and the inertia of the country's unfavourable demographic trends, there is excess production and a lack of confidence among the population when it comes to spending decisions, in a global context that seems unwilling to continue absorbing the country's manufacturing surplus. In the medium term, this is likely to place China's potential growth closer to 3%-3.5% than the official target of 5%. Meanwhile, in Europe, Germany's weakness is an accurate reflection of the challenges facing the region, as laid out perfectly in the Draghi report: a need to boost potential growth through innovation, productivity and public and private investment, as the only way to maintain (and to pay for) the European model. This plan, with an ambitious agenda of measures for change, sounds all well and good on paper, but to achieve these goals the bloc will need to overcome hurdles such as the reticence of the usual suspects, a governance structure with clear margin for improvement and the political balance of the new European Commission.

In short, 2025 will be a year in search of a new normal, threatened by the division between economic blocs. The hope is that, as is often the case in economics, that which we cannot see is just as important as that which we can, and sooner or later the potential benefits of artificial intelligence and of all kinds of innovations that are already in the pipeline should emerge. Meanwhile, the best outcome would be to regain multilateral cooperation in order to tackle the new challenges and spread the risks together. Right now, though, that seems more of a wish than a reality.

Monetary policy in 2025: dialling-back time

With disinflation on track and some signs of a slowdown in economic activity and a cooling of the labour market, monetary policy is shifting gears and starting to dial back the monetary tightening of the past years: going from restrictive to neutral. The ECB and the Fed, along with other major central banks, have initiated this easing process with interest rate cuts, and they are expected to continue doing so in 2025. From there, we will seek to clarify the factors that will guide this new phase of monetary policy.

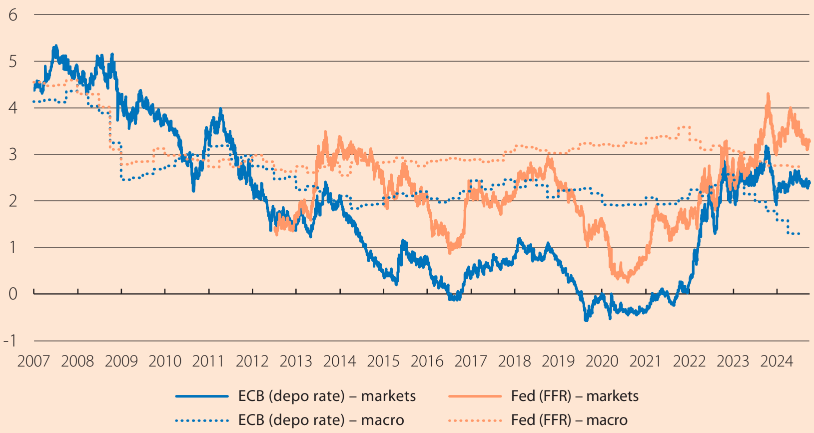
The path to neutral interest rates...

Both the Fed and the ECB have advocated a gradual approach. Although the ECB has lowered the depo rate from its peak of 4.00% down to 3.25% and the Fed has placed the fed funds rate in the 4.50%-4.75% range (vs. a peak of 5.25%-5.50%), these levels remain restrictive and the expectation is that, in a soft landing scenario, gradual rate cuts will continue in 2025.[1] However, several questions remain, such as how far rates will fall, how quickly they will do so, and how their reduction will be passed on to the wider economy.

The central banks' goal for 2025 is to bring interest rates to a level that neither stimulates nor cools the economy, but rather balances it with its potential growth. This equilibrium interest rate, also referred to as the natural or neutral rate of interest, is an unobservable and uncertain concept that guides the design of monetary policy. There are multiple ways to infer it, and we summarise two well-known approaches for the Fed and the ECB in the first chart: one based on macroeconomic models and the other on prices in the financial markets. These two options place the equilibrium interest rate in the US in the range of 2.75%-3.25%, while for the euro area it lies at 1.50%-2.50%.

Estimates of the equilibrium interest rate

(%)



Note: *The estimates of the «markets» correspond to forwards on the benchmark interest rates over a 5-year horizon. The «macro» estimates correspond to the natural rate of interest estimated by Holston* et al. *(2023), «Measuring the Natural Rate of Interest after COVID-19», plus an inflation rate of 2%.*
Source: *BPI Research, based on data from Bloomberg and the Federal Reserve Bank of New York.*

The speed with which the Fed, the ECB and the other central banks undertaking a monetary easing process will lower their rates to neutral levels will depend on how quickly or slowly the soft landing scenario materialises in their economies. In the euro area, the ECB could reach neutral territory as early as 2025, given the combination of tepid growth in the region on aggregate and the expectation that inflation will settle around the 2% target in the coming quarters (a view that is reinforced by the slowdown in wages and business margins).[2] In the US, our scenario is that the Fed will also reach neutral levels during the course of 2025, in order to avoid a sudden cooling of the labour market in the context of a disinflationary process which, with nuances compared to Europe, seems reasonably on track.

In this soft landing scenario, monetary easing will remove the burden on the economy in 2025. In fact, and as shown in the second chart, financial conditions have already been relaxed by the rate cuts (both those already implemented and those anticipated). Normally, monetary policy impacts the economy with long and variable lags (Romer and Romer [2023][3] place the maximum impact on GDP after a nine-quarter delay), so we should expect rate cuts to offer a moderate tailwind to GDP growth in 2025. However, estimates also suggest that the first positive effects are felt quickly: with highly granular data for the Spanish economy, Buda *et al.* (2023)[4] detect that changes in interest rates have a significant impact on consumption in less than a week, on business sales in about a month and on employment in about two months.

... and risks

The last question is what risks central banks will face in the new monetary phase. The first thing they must calibrate is the speed of the cuts. On the one hand, cutting rates too cautiously could cool the economy more than desired, risking a return to the

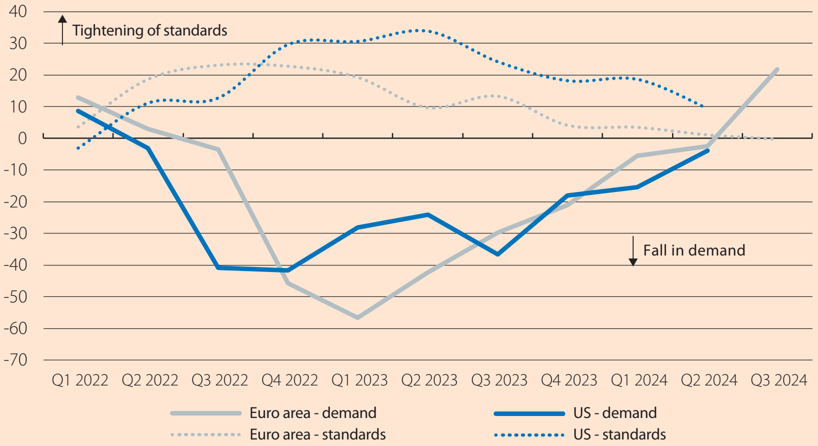
1. These rate cuts will coexist with a reduction of the central banks' balance sheets. See the Focus «Balance sheets: the not-so-visible normalisation of monetary policy», in this same report.
2. A cyclical recovery in productivity (for example, through an undoing of so-called labour hoarding) would further reinforce the decline in inflation.
3. C.D. Romer and D.H. Romer (2023). «Does Monetary Policy Matter? The Narrative Approach after 35 Years» (nº w31170). National Bureau of Economic Research.
4. G. Buda, V. Carvalho, G. Corsetti *et al.* (2023), «Short and Variable Lags», CEPR Discussion Paper nº 18022.

weak inflation of the previous decade. On the other hand, cutting them too quickly could compromise the inflation mandate: the central banks are in the last mile of the disinflation marathon, but they have not yet reached the finish line. The latest available data suggest that the ECB faces the first risk to a greater extent, with a loss of buoyancy already visible in the economic activity indicators, while the Fed faces the second, with an economy still growing above potential and inflation still showing some signs of resistance. In either case, the calibration of the monetary easing process will face a third ingredient: interest rates influence financial asset prices and drastic changes can lead to sharp corrections and trigger financial turbulence, as was the case during the period of rate hikes.[5]

The threat of further disruptions affecting the scenario must also be taken into consideration. However, the change in the monetary policy outlook in the event of a new shock, especially if it is on the supply side, should be mitigated by the fact that today the economies are starting from a position with tight financial conditions and a cooling of demand, which is radically different from the situation of 2022.

Evolution of financial conditions

Net balance of financial institutions (%)

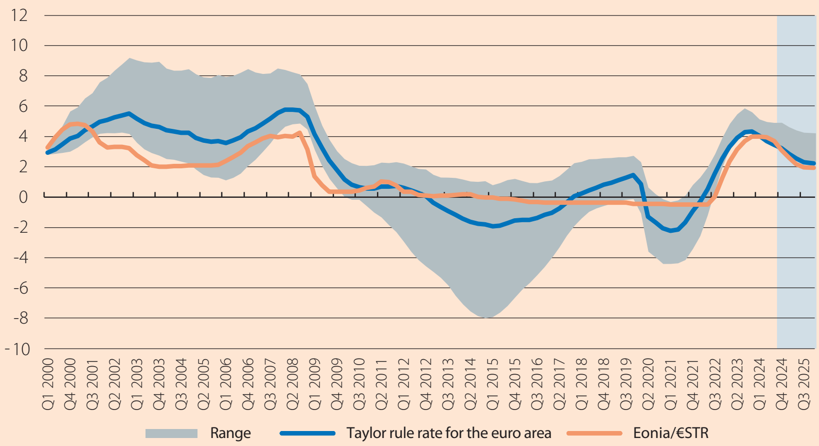


Notes: *Net balance of financial institution that tighten (+) or relax (–) their criteria for granting credit, or that of institutions that record an increase (+) or decrease (–) in the demand for loans. The indices reflect the weighted average for loans to non-financial firms, for home purchases and for household consumption.*
Source: *BPI Research, based on data from the ECB (Bank Lending Survey) and the Federal Reserve (SLOOS).*

Each central bank will have to gauge idiosyncratic risks in its respective region. The ECB faces the challenge of managing the euro area's disparities, where the strong growth of peripheral economies such as Spain (which is on track to be the fastest growing advanced economy in 2024) contrasts with the weakness shown by Germany (the only major advanced economy that is not growing in 2023-2024). This challenge makes the optimal monetary policy different for each country and means that different countries require different levels of interest rates. One way to illustrate this is with the Taylor rule.[6] This guide shows how historically some euro area countries would have needed higher interest rates than those set by the ECB, while other countries, with a weaker cyclical position, would have required lower rates. As can be seen in the last chart, the range of rates indicated by the Taylor rule suggests that the challenge remains present but, for the moment, the dispersion is smaller than it was in the past.[7]

Euro area: Taylor rule and ECB rate

(%)



Notes: *€STR in 2025 according to implied market rates. The range corresponds to the minimum and maximum rates prescribed by the Taylor rule for Germany, Spain, France and Italy. The Taylor rule used is:*

$$i_t = pi_{t-1} + (1-p)[r^* + 2 + 1{,}5(\pi_t - 2) + \tilde{y}]$$

*where $\tilde{y}$ is the output gap (observed GDP relative to its potential) and r^* is the natural rate of interest and **pi** is the observed inflation rate.*
Source: *BPI Research, based on data from the ECB, the European Commission, Eurostat, the New York Fed and Bloomberg.*

In the US, the big question which the Fed will have to manage will be the economic policy of the future White House administration, which could involve greater fiscal stimulus and more restrictive trade policies. The other source of risk arises from changes in the Fed's governing board itself, given that during the next administration two of its seven members will reach the end of their terms (Kugler in 2026 and Powell in 2028) and the positions of chair (2026) and two vice chairs (Barr in 2026 and Jefferson in 2027) will be up for renewal, all of which are nominated by the US president and approved by the Senate.

In short, all the indicators suggest that 2025 will be another year in which monetary policy will play a leading role in developments in the economic and financial markets.

5. With the collapse of Silicon Valley Bank in 2022 and the serious difficulties of NYCB in 2023.
6. This rule gives a nominal interest rate that should be set given a particular rate of inflation, neutral rate of interest and output gap.
7. There is lower dispersion in inflation rates compared to in previous years and, moreover, all economies are coming from a position of widespread weakness since 2020.

Outlook for the Portuguese economy in 2025: reinforcement of growth

After two years marked by the consequences of Russia's invasion of Ukraine – energy crisis, inflation, monetary tightening – the horizon for 2025 seems less charged. In fact, the outlook at the time of writing is one of a large number of central banks embarking on a cycle reversal and starting to cut benchmark interest rates.

The starting point

2024 kicked off with robust GDP growth (0.6% quarter-on-quarter in Q1 2024), which passed 60 billion euros for the first time at constant prices, supported by the good performance of external demand. In Q2 and Q3, performance was more modest (0.2% in both). This performance is in line with the narrative that the trajectory of year-on-year growth will be from «less to more», with the first part of the year still marked by the accumulated impact of rising interest rates, inflation and some political uncertainty with early elections, in March year-on-year growth of 1.4% in 1Q24. For 4Q? We expect an improvement that will allow us to close with an average growth of 1.7%.

At the same time, we recorded good news in the labour market and prices. The unemployment rate is at near record lows and although average inflation at the end of this year will still be above target, the inflationary surge has gradually dissipated and we even recorded a year-on-year rate below 2% in August. These two factors contributed to the recovery of real household income and supported the resilience of the real estate market.

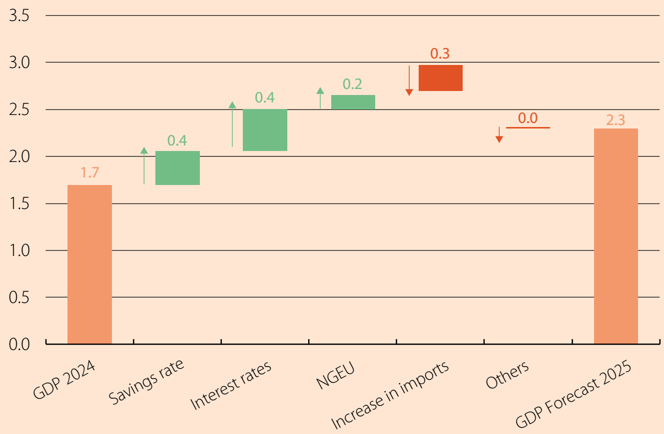
It is against this more positive backdrop,[1] albeit overshadowed by geopolitical risks, that we carry out the usual exercise of envisioning the *drivers* of Portuguese economic performance in 2025.

Outlook for 2025

We anticipate an acceleration in activity, which will translate into annual growth of 2.3%. The main factors behind this forecast are listed graphically, with the most notable contributions coming from the channeling of household savings into consumption, the fall in interest rates, and the receipt and implementation of European funds.

In the new series of national accounts, household savings and gross disposable income have been revised upwards, bringing the savings rate to 9.8%.[2] In a scenario in which the labour market remains strong – employment will grow by 1.3% and the unemployment rate will fall to 6.4% – and in which household income will recover, it is plausible to assume that households will be more inclined to consume. We therefore estimate a reduction of 1 pp in the savings rate – from the expected level of 9.7% in 2024 to 8.7% in 2025 – with a positive impact on growth of 0.4 pp.

GDP 2025: contribution of various factors to GDP growth
(p. p.)



Source: *BPI Research.*

The second factor influencing the acceleration of activity will be the ECB's monetary policy. It began cutting rates in June 2024 and is expected to cut interest rates by 100 bp in 2024 and a further 100 bp in 2025 in the face of a weakened European economy and a gradual slowdown in inflation. We therefore anticipate that the annual average of the 6-month Euribor – the main index in the Portuguese market – will fall to 2% (3.5% in 2024), taking pressure off the financial costs of families and companies, freeing up funds for consumption and investment. We estimate that this movement will translate into a positive contribution to growth of 0.4 pp.

The third driver of growth will be the acceleration in the implementation of European funds. The level of implementation of the RRP has been recovering, but it is still low.[3] However, measures have been adopted to accelerate it and, bearing in mind that 2025 will be the penultimate year of the NGEU, the 2025 State Budget foresees an increase in capital expenditure related to the RRP of 0.9 pp

1. BPI Research, like the Bank of Portugal (October 2024 Economic Bulletin) and the Government (2025 State Budget), for example, predict growth in 2025 will be higher than this year (and above 2%).
2. The historical average savings rate is 9.4% and the average over the last five years before the pandemic was 6.8%.
3. At 16 October, the payment rate for the amounts approved was 27%.

in GDP compared to 2024. We estimate that this will have a positive impact on growth (+0.2 pp). However, given the high import content of demand in Portugal,[4] we believe that the increase in investment, together with the strength of consumption, will increase imports, removing around 0.3 pp from GDP in 2025.

In the tourism sector, we estimate a 4% increase in the number of guests. The perception of Portugal as a safe country away from conflict zones, the recovery of household disposable income in the domestic market (and the main source markets), and the increase in hotel supply will all contribute to this. However, the contribution to growth should be roughly the same as in 2024 and will not be an additional driver of growth in 2025.

Macroeconomic Scenario

	2023	2024F	2025F
Δ GDP (%)	2.5	1.7	2.3
Private consumption	2.0	2.2	1.7
Public consumption	0.6	1.0	0.8
GFCF	3.6	1.3	5.7
Exports	3.5	4.2	5.0
Imports	1.7	4.6	5.0
Global inflation (%)	4.3	2.4	2.1
Unemployment rate (%)	6.5	6.5	6.4

Source: *BPI Research.*

We are confident that these will be the drivers of growth in 2025, but once again, it will be a year enshrouded in risks, especially external ones, such as the possibility of a worsening of the conflict in the Middle East, which could lead to an increase in the price of important raw materials, delaying the disinflationary process and putting a brake on the relaxation of monetary policy. A possible increase in global protectionism following the US elections would also penalise Portugal, as we are a small, significantly open economy. But not all risks are negative and, if geopolitical issues don't worsen, disinflation could accelerate, with a positive impact on productive activity through greater domestic and foreign demand.

Teresa Gil Pinheiro
Tiago Belejo Correia

4. See article «The imported content of final demand in Portugal: nominal and real evolution», Revista de Estudos Económicos - Vol 5, N.3, BdP.

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