Economic, sectoral and regulatory environment

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2.1 Economic and financial environment

The main factors at play in 2023 were the interest rate hikes carried out by central banks.

The main factors at play in 2023 were the interest rate hikes carried out by central banks and the progressive transfer of their impact to economic activity. The cycle of interest rate hikes only came to a halt in the final part of the year when the monetary authorities indicated that rates had already reached sufficiently restrictive levels. The progress seen over the year in the process to reverse inflation, which now demonstrates a clear downward path, was the main factor enabling the central banks to adopt a more relaxed position. In terms of economic activity, the Eurozone and UK economies suffered more in this environment and maintained a situation of virtual stagnation, while the United States proved to be more resilient and surprised to the upside. On the other hand, a number of specific episodes of uncertainty, of different kinds, emerged over the year, among them the collapse of certain US regional banks, the problems at Credit Suisse and the beginning of the armed conflict in the Middle East between Israel and Hamas. The economic repercussions of these events were mostly contained and short-lived. Lastly, in the financial markets, 2023 was a positive year for most financial assets, following 2022 when a large portion of assets recorded heavy losses.

Geopolitical environment

Geopolitical events continued to represent a vector of uncertainty across the global panorama. The outbreak of a new conflict between Israel and Hamas in the final part of 2023 rekindled instability in the Middle East. With the outbreak of the conflict, Arab countries that had normalised relations with Israel under the Abraham Accords paused the peace process and/or placed it under review. The greatest risk lies in a potential escalation of the conflict at a regional level, which could cause disruption to oil and gas supplies. The most recent developments in this conflict were the attacks by Yemen's pro-Palestine Houthi rebels on cargo ships in the Red Sea, disrupting maritime traffic in the region.

On the other hand, the conflict between Russia and Ukraine became deadlocked and Ukraine remains divided on its eastern side. In the Western world, sanctions against Russia continued and support for Ukraine, both military and economic, was maintained, although the "fatigue" evident among several Western States raises doubts about what may happen going forward.

In the background, the geostrategic contention between China and the United States continued, and the emergence of the Global South as a player to be reckoned with in international relations took on new importance. The greater relevance of these countries at multilateral meetings, such as the G20, or in alternative groupings, such as BRICS (particularly after its forthcoming enlargement was announced), were at the centre of the geopolitical debate.

Economic activity and inflation

The evolution of the global economy showed a marked divergence between the dynamism of the US economy, which proved to be stronger than expected, and the European economies, which lagged and were practically stagnant throughout the year. Spain continued to outperform other Eurozone countries, while China was affected by the impacts of its real estate sector adjustment.

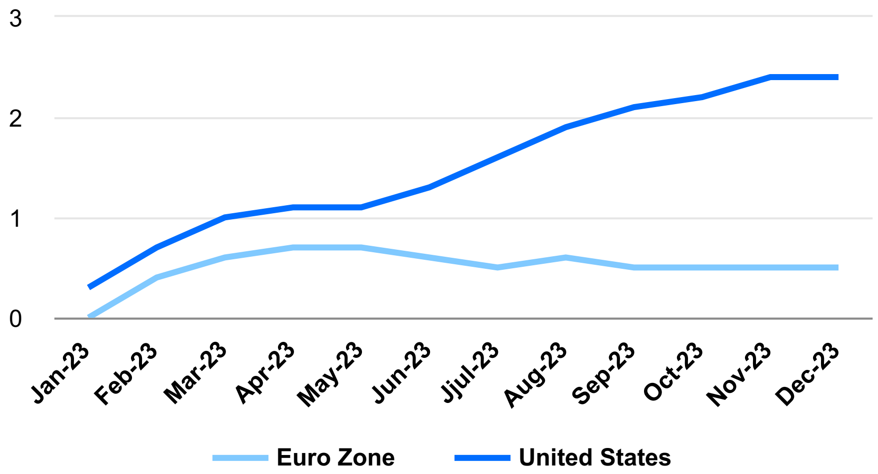
In 2023, inflation gradually eased from the peaks observed in 2022.

In the Eurozone, economic activity remained practically stagnant throughout the year. The economy was weighed down by monetary policy tightening, weak domestic demand and a sluggish industrial sector, particularly in Germany, which remains affected by the energy crisis. In fiscal matters, EU governments formally agreed on a proposal to reform the European bloc's tax framework at the end of 2023. This proposal will need to be negotiated with the European Parliament and is expected to come into force before the European elections scheduled to take place in June 2024. In the United Kingdom, economic activity remained weak for most of the year, with growth diminishing as the year progressed. Higher interest rates and inflation dampened domestic demand. In the real estate sector, prices fell with respect to the peak seen in 2022. In the United States, however, economic activity was more solid and the growth forecasts for 2023 were continually revised upwards. Domestic demand and, in particular, private consumption were the main levers for growth during the year. The labour market remained solid throughout the year and the unemployment rate stayed below 4%. Nevertheless, the cooling was more evident in the reduced number of vacancies, with job market tension easing.

The global economy showed sharp divergence between the dynamism of the US economy and stagnation in the Eurozone and the UK.

The evolution of the economic growth forecast for 2023 revealed a significant gap between the Eurozone and the United States.

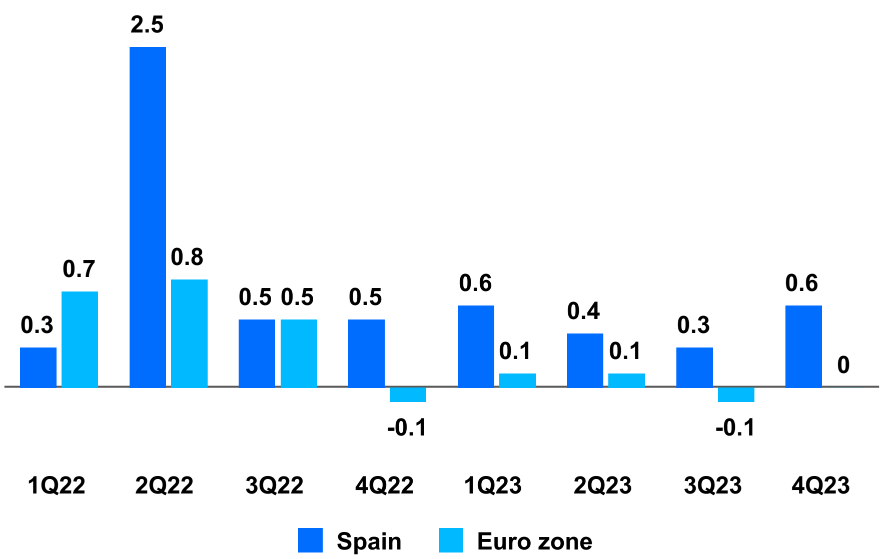
Economic growth of the Eurozone vs United States
Source: Consensus Economics.



Spain's economy continued to stand out in a positive light in the Eurozone.

In Spain, the economy followed a similar growth pattern throughout the year, despite a backdrop of rising interest rates, weaker export market performance and a loss of momentum due to the post-pandemic reopening. Growth forecasts for 2023 improved as the year progressed, and the performance of the Spanish economy ended up being much more favourable than that of the Eurozone as a whole. This improved comparative performance was accompanied by greater weight of the service sector (in a context of weakness in industry), less exposure to China's economic slowdown, lower inflation during much of the year, and a better balance sheet position among private sector players.

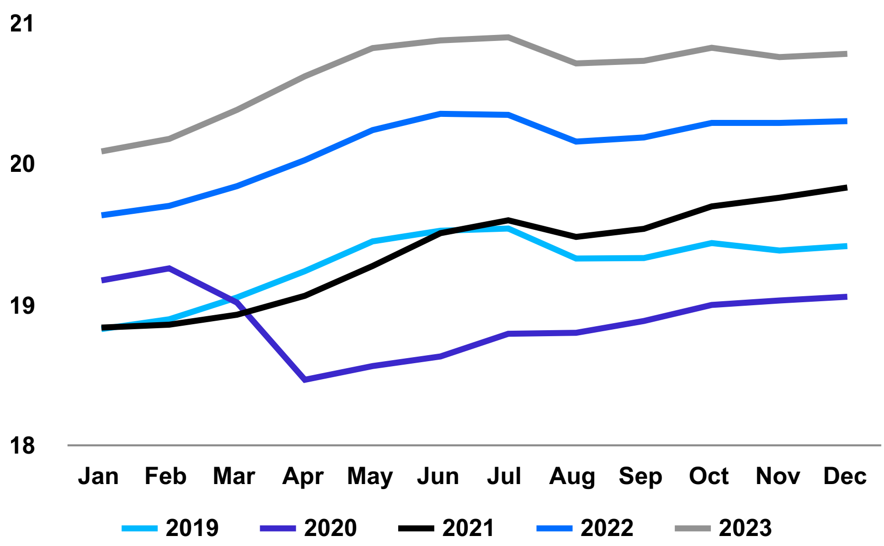
GDP growth of Spain vs Eurozone (quarterly variation, %).
Source: Eurostat.



In 2023, growth in Spain was driven by private consumption, in turn supported by revived purchasing power among households and good performance of the labour market. Consequently, unemployment reached its lowest rate since 2008 and the job occupancy rate hit a record high, with significant dynamism in high value-added sectors and a marked recovery of immigration, which boosted the labour force. On the other hand, investment in residential property, impacted by the fall in mortgage lending, remained far from its pre-pandemic levels, while business investment was also persistently sluggish.

Job occupancy in Spain is at a record high.

Workers enrolled in Social Security (millions).
Source: Ministry of Social Security.



With regard to economic policy in Spain, it is worth mentioning the approval, early in the year, of the second part of the pension reform, which aims to increase the income obtained through the system. In the second quarter, the government extended most of the measures to alleviate the impacts of the energy crisis until the end of the year. Subsequently, in December, the government approved a decree to further extend several of these tax breaks, as well as an extension of the scope of the Code of Good Practice to encompass mortgage borrowers and the extension of the bank levy during 2024. Lastly, the European Commission's approval of the addendum to the Spanish Recovery Plan, which will mobilise an additional 94 billion euros related to the NGEU funds, is also worthy of mention. With regard to the political landscape, snap general elections took place in July, after which a coalition government was formed between PSOE and Sumar, supported by various parties from the autonomous communities.

The emerging economies generally proved to be resilient, despite the high interest rate environment at a global level. The region benefited from the post-Covid reopening in China and from commodities prices, which remained at high levels. The industrial offshoring trend, arising from a more fragmented geopolitical environment, could also be an additional support for some emerging countries. In Mexico, for example, investment grew at historic double-digit rates, partly due to nearshoring with the United States. Also worth noting is the positive turnaround of the management of economic policy in Turkey, which developed a more orthodox approach. In this context, the process to reverse inflation in emerging economies progressed and some central banks (particularly in South America) were able to reduce their official interest rates.

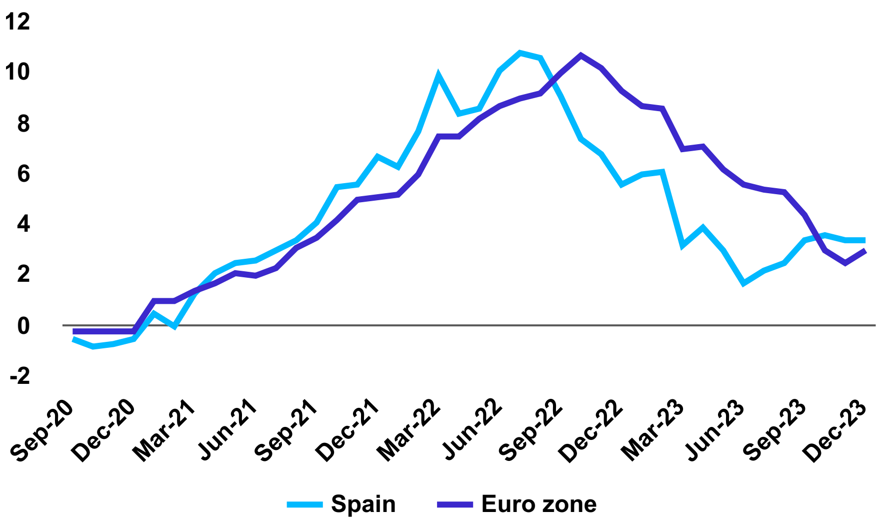
In China, the post-Covid reopening drove growth, although the recovery was slower than expected. A lack of household confidence in the real estate sector and delayed decision-making on household investments weighed on China's recovery. In this context, the adjustment of the real estate sector, already underway since 2021, intensified. The liquidity problems of real estate developers worsened and fears grew that defaults might become more widespread in the sector and could also spread to local governments. This problem was kept in check as public sector real estate developers, in a better position in terms of liquidity and leverage, were able to sustain the sector. In addition, lending flows to the industrial sector continued, and private investment in the manufacturing sector grew at robust rates.

In 2023, inflation in the main developed economies eased from the peaks observed in 2022. Once the energy crisis and supply chain issues were resolved, the correction of energy prices and industrial goods was, to a large extent, the force behind the moderation of headline inflation. The evolution of core inflation, which is more affected by the service sector and wage dynamics, was more subdued, although it also showed a clear downward trend.

In the Eurozone, inflation continued to ease, with the year-on-year rate falling below 3.0% for the first time since July 2021, due to the energy component in particular. Core inflation, which excludes energy and food, also eased, although it remained at historically high levels. In the United Kingdom, headline inflation fell from the peaks seen in 2022, but the pressure shifted to core inflation, which reached its highest levels since 1992. Pressure from the service sector combined with increased food prices drove inflation in the UK to levels worse than its peers. The sharp tightening of the labour market, where wages increased by more than 8% year-on-year, also contributed to the persistence of inflation. In the United States, inflation continued with its gradual slowdown, although it remained above the monetary policy target. Wages gradually moderated from the second half of the year onwards, which served to contain the pressure on the underlying index.

In Spain, inflation was influenced by the base effect of energy products, with the year-on-year rate presenting a downward trend and falling below 2.0% in June. After that, the base effect began to work in the opposite direction, raising the year-on-year rate of inflation once again. Core inflation, on the other hand, followed a gradual slowing trend, influenced in particular by slower price growth in the industrial sector which, unlike the service sector, was less affected by the increase in labour costs.

HICP for Spain vs Eurozone (year-on-year change in %). *Source:* Eurostat.

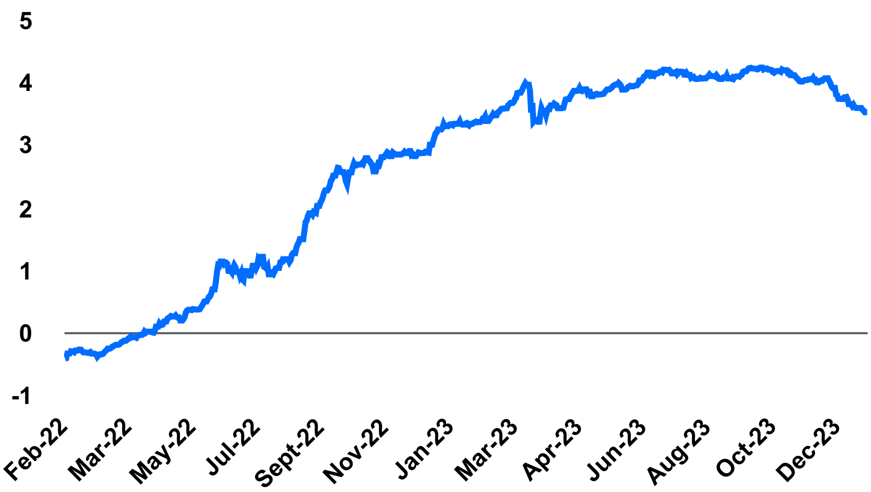


Monetary policy

During 2023, the central banks of developed countries continued their cycle of interest rate hikes, although the pace was somewhat less intense than in 2022. It was only towards the end of the year that they considered that rates had reached sufficiently restrictive levels to keep inflation under control, at which point they indicated that the rate hike cycle might have reached its end.

In the Eurozone, the European Central Bank (ECB) implemented an unprecedented tightening of its monetary policy. Thus, it continued with the rate hike cycle that had begun in 2022 and ended the year with the deposit facility rate standing at a record high of 4.00%. In addition, the size of its balance sheet continued to shrink, due to the maturity of TLTRO III funding transactions and the beginning of the process to reduce its holdings of assets bought under its APP. Additionally, it announced that it would stop reinvesting a portion of maturing securities purchased under the PEPP asset purchase programme in the second half of 2024. Meanwhile, the ECB stopped remunerating banking institutions' mandatory reserves.

12M Euribor (%). *Source:* Refinitiv.



In the United States, the Federal Reserve (Fed) continued to pursue its rake hike cycle, with official interest rates reaching a range of 5.25%-5.50% mid-year. At its last meeting of the year, the Fed signalled that the rate hike cycle had come to an end and that it would even begin discussions about future rate cuts, which provided additional support for the performance of various financial assets. In terms of balance sheet policy, its balance sheet reduction was interrupted following the financial instability triggered by the collapse of Silicon Valley Bank, as a result of which the Fed established new extraordinary funding facilities for the banking system. Nevertheless, once the event was resolved, the Fed continued its balance sheet reduction by electing not to reinvest maturing debt.

In the United Kingdom, the Bank of England (BoE) raised the base rate to 5.25%, after inflationary pressures intensified at the beginning of the year. In addition, it continued with the balance sheet reduction programme, unwinding practically all of its corporate bond holdings (around 18 billion pounds) and 93 billion pounds of government debt acquired under the Asset Purchase Facility (APF). In the same vein, the BoE announced that it would continue to downsize its balance sheet and estimated a further reduction of 100 billion pounds of government debt holdings in the next tax year (October 2023 - September 2024).

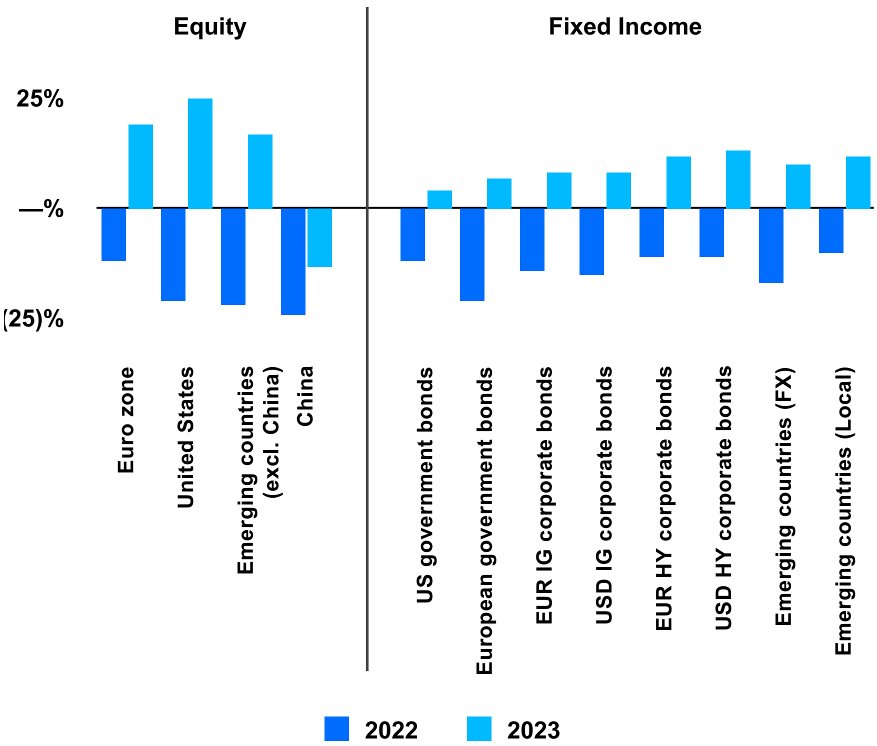
In Mexico, the central bank ended its rate hike cycle in the first half of the year with the official interest rate standing at 11.25% and kept it unchanged during the second half of 2023. Banxico has not yet begun to discuss possible rate cuts and continued to hold the opinion that inflation risks remained skewed to the upside. This stood in contrast with the situation of other Latin American countries, such as Brazil, Chile and Peru, where the central banks started to make rate cuts in the second half of the year. This was also the tone in China, where the authorities adopted monetary loosening measures, albeit cautiously, to support economic recovery. By contrast, benchmark interest rates were hiked sharply in Turkey, in a context of double-digit inflation.

Financial markets

Financial markets performed better in 2023 than in the previous year.

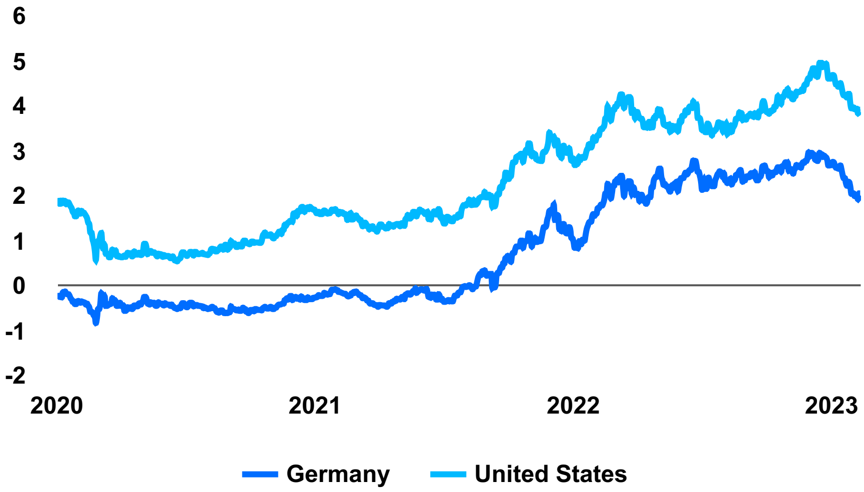
The financial markets performed better in 2023 than the previous year, when a large portion of financial assets posted heavy losses. The liquidity problems related to the US regional banking industry and the outbreak of the conflict between Israel and Hamas had an initial negative impact, but this was quickly and fully reversed. Government bond yields showed a rising trend for a good part of the year, but the trajectory was completely reversed towards the end of the year, in response to some downside surprises in inflation data and the Fed's monetary policy turnaround. The improved performance of risk assets was related to the end of the central banks' cycle of rate hikes, the forthcoming rate cuts priced in for 2024 and the boom in companies related to artificial intelligence. The risk premiums of European peripherals and corporates held up well. On the other hand, the euro exchange rate against the dollar displayed pronounced volatility, swinging back and forth according to the interest rate differential and the divergence of economic growth across regions.

Returns on various financial assets (in %, by year). *Source:* Refinitiv.



Long-term government bond yields showed a rising trend for much of the year. In the United States, the yield on 10-year bonds reached its highest level since 2007, while in Germany it reached levels not seen since 2011. Yields were driven upwards by pressure from monetary policy tightening, the resilience of the US economy and concerns regarding high levels of need for sovereign debt funding (exacerbated by the deterioration of US public accounts). The latter had a particularly marked impact on the financial markets due to the context of balance sheet reduction by central banks and the shift in demand for public debt towards more price-sensitive investors. In the last two months of the year, some unexpected falls in price data and a shift in the central banks' communication policy (particularly that of the Fed) led to a turnaround in yields, which completely reversed the upward trend seen over the year. The yield on US 10-year government bonds ended the year at the same level as 2022, while that of the German 10-year bund ended the year 50 basis points lower.

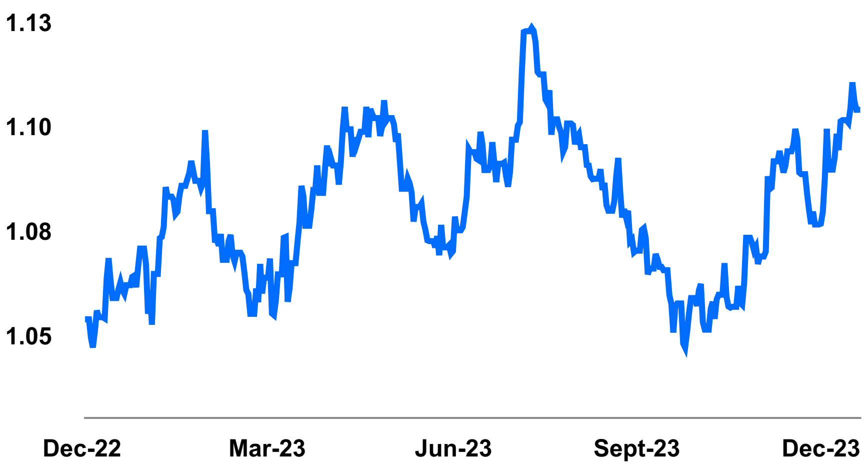
US and German 10-year government bond yields (%). *Source:* Refinitiv.



The risk premiums on peripheral sovereign debt were at lower levels than those seen at the end of 2022, supported by the ECB's emergency purchase programmes, the European Union's NGEU funds and some positive actions undertaken by the rating agencies. The Italian sovereign risk premium was pushed up towards the end of the year, due to poor performance of the public accounts and an upward revision of forecasts for the budget deficit in the coming years. Despite this, the main rating agencies kept Italy's credit rating unchanged and Moody's even improved its outlook from negative to stable (Moody's rated Italy's debt on the lowest notch of investment grade). On the positive side, Greece performed well, obtaining an investment grade rating for its public debt from rating agency Standard & Poor's for the first time since 2010. Furthermore, Fitch and Moody's raised Portugal's rating to A-.

With regard to developed countries' currencies, the US dollar posted numerous swings in its exchange rate against the euro, finishing the year at somewhat lower levels compared to the end of 2022 (EUR 1.00 = USD 1.10). The currency was mainly affected by the divergence between the Fed and the ECB's respective stances on monetary tightening, and concerns regarding global economic growth. The risk episodes related to liquidity problems in the US regional banking industry and the outbreak of the conflict between Israel and Hamas only gave piecemeal support to the US currency. The pound sterling appreciated slightly against the euro, due to greater interest rate tightening by the BoE.

USD/EUR. *Source:* Refinitiv.



The equity markets performed well, following significant corrections in the previous year. Most of the global stock market indices managed to post gains. For example, the Stoxx 600 advanced by more than 12% year-on-year, while the IBEX 35 managed to post a 20% gain. Stock market increases were also significant in the United States, above all in the case of tech companies (the Nasdaq managed to gain over 40%).

In emerging economies, sovereign risk premiums were slightly reduced over the year. The outbreak of the conflict between Israel and Hamas towards the end of the year had a limited impact on emerging markets. Yields on long-term domestic government bonds, in general, shifted downwards over the year, with the main exceptions of Mexico (where they were pushed up by US yields) and Turkey (due to the benchmark rate hikes). With regard to exchange rates, the high official interest rates in emerging countries continued to serve to support emerging market currencies. The Mexican peso performed particularly well in this respect. Conversely, it is worth highlighting the significant depreciation of the Turkish lira due to reduced currency intervention by the country's authorities, and the devaluation of the yuan, in a context of portfolio outflows and lower foreign direct investment in China.

On the other hand, the cryptoassets market registered a slow and partial recovery in 2023, following the significant correction that occurred in 2022 due to the collapse of numerous large crypto entities. This recovery was partially supported by expectations of United States approval of Exchange Traded Funds (ETFs) that invest in bitcoin for cash, which, according to analysts, could attract traditional investors to this market. Nevertheless, its valuation is still far from the historical peaks recorded at the end of 2021.

2.2 Financial sector environment

Banking sector

The banking industry showed adequate levels of capital and higher profitability thanks to improved interest income.

The global banking sector registered sporadic episodes of instability in the first half of 2023, which were confined to the collapse of the US regional banks Silicon Valley Bank (SVB) and Signature Bank in March, and the acquisition of First Republic Bank by JP Morgan in May. SVB faced a significant liquidity crisis, stemming from poor management of its balance sheet (asset side heavily invested in long-term public debt and mortgage-backed securities at a time when interest rates were low, and a high concentration of deposits in the hands of relatively few customers) and a lack of regulation and supervision of small and medium-sized banks in the United States. In the end, the FDIC (US deposit insurance fund), the Federal Reserve and Treasury intervened to protect all funds held by depositors at SVB and Signature Bank, which faced similar problems. As for Credit Suisse, in a deal brokered by the Swiss government, the bank was acquired by UBS. The agreement included writing off the investment of Credit Suisse AT1 bondholders, meaning that shareholders were not the first to fully absorb the losses; this had implications for the AT1 market. The monetary and regulatory authorities in the various jurisdictions took prompt action and introduced measures that were effective in containing the financial contagion. This, together with the existing differences between the banks concerned and the rest of the sector, meant that the consequences were limited.

These episodes led to a review of the regulatory and supervisory framework for regional banks in the United States. In the EU, attention shifted to the need to strengthen the supervisory framework. This had consequences for the European construction process, leading the European Commission to propose a reform of the bank crisis management and deposit insurance framework (CMDI) for medium-sized and smaller banks. Other debates that arose at global level concerned (i) how to stem the rapid outflow of deposits at times of stress, as these are carried out digitally and are therefore more difficult to control than physical withdrawals, and (ii) the need to review the level of coverage of the deposit guarantee scheme and increase the maximum threshold of guaranteed deposits in different jurisdictions. Elsewhere, in the United States and the United Kingdom, the entry into force of Basel III was postponed to June 2025.

Throughout 2023, several governments introduced a windfall tax on the banking sector and other unorthodox measures. The main objectives were to increase their tax contribution and mitigate the impact of interest rate hikes on other players in the economy. With regard to tax, the cases of Spain and Italy are worth mentioning in particular. In Spain, the tax on extraordinary profit of banks, applied to 2022 and 2023 earnings, was approved amidst the unfavourable opinion of the ECB and IMF because of its design and its impacts on the banking sector. Subsequently, the government extended the measure for a further year. In Italy, the government had to water down the design of the tax so that, ultimately, banks had the option of increasing provisions to avoid paying the tax. Other measures adopted by EU governments included greater pressure on banks to regulate their prices, compelling banks to sign mortgage moratorium agreements and establishing taxes on share buybacks carried out by banks.

In the year overall, the general situation of banks was one of adequate capital levels, with a CET1 capital ratio that, according to the authorities, would remain above the minimum required by regulations, even in an adverse scenario. The interest rate hikes implemented by central banks had a positive effect on banks' results, in spite of the fact that as interest income increased, funding costs also became more expensive. European banks operated in a less liquid environment following the maturity of the bulk of TLTRO III borrowing, although this did not have a very significant impact on regulatory liquidity ratios, which remained comfortably above the regulatory minimum and market requirements. Asset quality did not appear to deteriorate, although concerns grew about the performance of the commercial real estate sector, above all in the United States. In general, the conditions applicable to bank loans in the main developed economies were compatible with tightening financial conditions.

With regard to the Spanish banking sector, the Bank of Spain (BoS) indicated that, in the scenario of heightened uncertainty and increased risk arising from geopolitical tensions, Spanish banks continued to present a favourable evolution in terms of profitability, solvency and default rates. Financing costs were gradually being adapted to the new interest rate regime. Banks replaced ECB funding with debt issues (mostly senior debt) and interbank market transactions (repos). Spanish banks maintained a relatively high liquidity coverage ratio (LCR) relative to comparable countries, although the ratio had fallen significantly since 2021 due to the reduction of surplus reserves deposited by banks with the ECB. The pass-through of monetary policy tightening to interest rates was more pronounced in loans than in deposits; this was partially due to the ample liquidity that banks were operating with at the time. Nevertheless, the Bank of Spain anticipated a gradual increase in costs associated with liabilities going forward. On the other hand, it continued to ask banks to increase their provisions.

Financial stability and macroprudential policy

Throughout 2023, the financial authorities maintained that the risks of financial instability at a global level were high and they appeared more concerned following the beginning of the conflict in the Middle East. Other focal points in the year included a potentially disorderly correction of prices in the commercial real estate sector (above all in the United States, but also in some European countries), the situation facing companies, the economic weakness of certain economies such as China, and the potential price adjustment of financial assets.

The authorities continued to warn about risks in the non-bank financial sector (NBFS), although little progress has been made with its regulation. In terms of risks, of particular note were the increase of synthetic and financial leverage, which can spread risks throughout the financial sector and trigger disruption; structural liquidity imbalances, with a potential to spread contagion to the rest of the financial sector; and counterparty credit risk produced by exposure of bank derivatives to the non-bank financial sector (NBFS). In Europe, the authorities showed concern about collateralised loan obligations (CLOs) as, up to now, they have only existed in a low interest rate environment.

The European authorities decided not to proceed with macroprudential policy reform, which they had planned to include in Basel III legislation, postponing it until the beginning of the new European legislature in 2024, at the earliest. European countries did not make progress with the accumulation of countercyclical capital buffers (CCyB), unlike in 2022, and the Bank of Spain kept Spain's at 0% due to the moderate evolution of lending and the real estate market. However, the European and global authorities called for the CCyB to be raised to positive levels when financial conditions return to normal, which began to put pressure on the national authorities to consider raising this buffer to around 2%.

Banking Union and Capital Markets Union

Progress made in terms of European reconstruction was affected by the banking sector episode of March 2023. In April, the European Commission proposed a reform of the bank crisis management and deposit insurance framework (CMDI) for medium-sized and smaller banks. The proposal maintained the limit of 100,000 euros for deposit guarantees. The proposed measures sought to incentivise resolution rather than liquidation in the event of a crisis in medium-sized and smaller banks, with the aim of limiting the use of taxpayer money in the event of a banking crisis and to protect depositors. To that end, if a bank went into resolution and if a point was reached where the depositors would be forced to assume losses, the deposit guarantee fund would absorb those losses first, rather than the depositors. In addition, the deposit guarantee framework was harmonised across different countries and its coverage was extended to also encompass public entities and money deposited by customers in certain non-bank financial institutions, and allowing a guarantee of more than 100,000 euros in specific cases such as house purchase transactions, receipt of insurance compensation and inheritances. The proposal has to be discussed by the European Parliament and the Council and, after that, the ECB will give its opinion, although both the central bank and the Single Resolution Board backed the measures.

Also related to bank resolution, the European Stability Mechanism (ESM) will not ultimately be the backstop for the Single Resolution Fund (SRF), due to Italian opposition, which limits the resources currently available to the European framework to cope with potential needs to resolve large banks or manage systemic events.

The European Deposit Insurance Scheme (EDIS) was maintained without improvements, despite the initial pressure to renew the debate following the episode in March. No progress was made with the Capital Markets Union either.

Challenges for the banking industry

Sustainability continued to feature on the supervisory agenda in 2023. The ECB published its second climate stress test (the first was published in 2021) for the economy as a whole, in which it was shown that the best way to achieve a net-zero economy is to accelerate transition, with more decisive policies. Additionally, the European Banking Authority (EBA) published its report on the incorporation of climate risks in the prudential framework for credit institutions and investment firms in which it recommends measures to accelerate the inclusion of environmental and social risks in Pillar 1. The report does not advocate the introduction of a green supporting factor nor that of a brown penalising factor, but it does adjust probabilities of default (PD) and loss given default (LGD) and proposes a series of measures to be adopted in the next three years. In addition, the European Green Bonds Standard was approved, which will foreseeably start to be applied at the end of 2024. The standard is voluntary and establishes uniform requirements for bond issuers that use the term “European green bond” or “EuGB”, thus facilitating consistency and comparability in the green bond market and reducing greenwashing risks. The Spanish Macroprudential Authority (AMCESFI by its Spanish acronym) published its first report examining the potential impact of climate change risks on the Spanish financial system under the scenarios used by the international authorities. The report indicates that drought events and severe heatwaves could have a negative impact on the solvency and profitability of banks, but considers that the exposure of banks’ mortgage portfolios to flood risk is limited. The European Commission published a new package of measures to strengthen the EU Sustainable Finance Framework and contribute to the European Green Deal objectives. In relation to the COP28 climate summit, various commitments were adopted, such as a greater contribution from developed countries to the loss and damage fund for climate events and the use of renewable energy, whilst recognising for the first time, in its final agreement, that countries must move away from fossil fuels and switch to alternative energy sources in a fair, orderly and equitable manner in the coming years. In relation to international initiatives: (i) the United Nations Environment Programme (UNEP) published its second biennial report on progress with the implementation of the United Nations Principles for Responsible Banking, which considers that considerable progress has been made with the publication of the social and environmental impacts on portfolios, (ii) the TNFD published its final recommendations for the management and disclosure of nature-related risks and a guide to implementation, the equivalent of the climate-related recommendations of the TCFD, and (iii) the NGFS published an initial version of its guidelines for the supervision of nature-related risks. Other focal points included the increase of litigation risk, above all in the United States, and the withdrawal of insurance coverage in certain areas.

Digitalisation processes continued at an increasingly fast pace, giving rise to several focus areas. On one hand, in spite of the continued advance of Bigtech in the financial services sector and the banking industry’s repeated calls for regulations that adhere to the principle of “same activity, same risk, same regulation”, the progress made in this regard was very limited. Another topic that continued to cause considerable concern was the proliferation of cyberattacks, which were becoming more frequent and more severe.

With regard to the regulation of digitalisation, following the crypto crashes of 2022 and in light of the evidence found that risks had not been transferred from the crypto ecosystem to the traditional financial system in this case, only because links between the two are, for the moment, limited, the authorities saw the urgent need to regulate these markets before those links could develop and pose a systemic risk to financial stability. Thus, the authorities proceeded with initiatives to strictly regulate the cryptoassets markets, particularly in the EU, where the Markets in Crypto Assets (MiCA) regulation was approved mid-year. The MiCA regulation will enter into force between 12 and 18 months following its approval and the European supervisory authorities began to publish proposals on the requirements to be established so that they may implement the supervisory responsibilities arising from MiCA.

The authorities in the United Kingdom also made progress in these matters, albeit rather more slowly. In the United States, legislative proposals to regulate these markets did not make any meaningful progress, but the federal agencies, particularly the Securities Exchange Commission (SEC), put increased regulatory pressure on the main cryptoasset exchanges and, in numerous cases, began legal proceedings against these entities. As for the Basel Committee, in June it published the final version of its corresponding standard on prudential treatment, which banks will be required to apply to their cryptoasset exposures as from 1 January 2025.

With regard to central banks' digital currencies, these plans continue to develop. In particular, the digital euro project made progress in 2023. The ECB completed the research phase, which took two years, and began the preparatory phase, which is expected to take another two years. The ECB published a report with the findings of the research phase, which gave details of the characteristics that the digital euro would have if it were ultimately issued. The preparatory phase will include finalisation of the rules of operation and the selection of service providers that could develop the platform and infrastructure. For its part, the European Commission published a proposal for a regulatory framework for the digital euro; discussion of this framework is expected to be postponed until after the 2024 European elections.

China continued to progress with the digital yuan, extending its use to, among other things, specific stock market transactions, as well as cross-border payments. In February, the United Kingdom published a document on its digital pound project. Meanwhile, the United States kept its digital dollar plan at a more preliminary stage and, for the time being, has not seen clear reasons to move it forward. Significant progress continued to be made with research projects on the possibilities of interoperability between the digital currencies of the different central banks, in large part led by the Bank for International Settlements (BIS). In parallel, the BIS and the IMF began to jointly push for the development of public financial infrastructures in Distributed Ledger Technology (DLT), under rules to be established by the central banks, and the tokenisation of traditional financial assets.

2.3 Outlook for 2024

Global economic growth in 2024 is expected to be weak and below potential, affected by the impacts of tightened monetary policy. In terms of regions, the structural adjustments in China are expected to continue, while in the Eurozone, Germany's weaker performance will contrast with the periphery countries that benefit from NGEU funds. As for the United States, an economic slowdown is expected in 2024. By contrast, Mexico is expected to see a more pleasing growth dynamic than the United States, supported, to some extent, by nearshoring, a favourable labour market and the absence of financial imbalances.

It is expected that inflation will continue to gradually ease towards monetary policy targets, although these will not be achieved until the end of 2024 or beginning of 2025. Inflation dynamics will be largely determined by domestic factors, such as the job market, the real estate market and the fiscal policy of each country. Unstable supply conditions could generate new disruptions in production chains and new specific cost pressures.

In terms of economic policy, it is likely that central banks will cut interest rates as inflation moderates and gets closer to their targets, in order to avoid a further rebound of the real interest rate. Throughout this process, central banks could be forced to tolerate inflation rates somewhat higher than their targets, if that serves to avoid a potential financial crisis and significant recession.

In relation to the financial markets, it is expected that short-term government bond yields will gradually decline alongside official interest rate cuts. Long-term government bond yields are expected to remain relatively stable, despite weak economic growth and easing inflation, due to concerns about the fiscal situation, particularly in the United States. Corporate risk premiums could climb to levels higher than the average of the last few years. In relation to sovereign debt risk premiums in the European periphery, it is expected that these will remain at contained levels and in line with their respective ratings.

With regard to the currency market, it is anticipated that the US dollar will gradually depreciate once further weakness in the US economy becomes apparent and the Federal Reserve starts to cut interest rates in 2024.

Spain continues to outperform the rest of Europe in this environment. In this respect, the recovery of real household incomes stands out as a key tailwind, thanks to the favourable evolution of the labour market, higher wages and lower inflation. In addition, business investment has been supported by fewer supply chain issues, the NGEU funds and tenders for public works associated with them, and by liquidity on corporate balance sheets.

In the financial environment, profitability in the banking sector is expected to moderate, as net interest income will provide less support, and asset quality is expected to deteriorate slightly. On the other hand, further progress is expected on the global regulatory framework for activities linked to cryptoassets and on central banks' plans to issue digital currencies.