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Economic note

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1. Silicon Valley Bank … history repeats itself

Last December marked 4 years since the death of the ex-Chairman of the United States Federal Reserve (the "Fed"), Paul Volcker. Volcker was in charge of the North American monetary policy between 1979 and 1987 under the government of two presidents: the democrat Jimmy Carter, who appointed him, and the republican Ronald Reagan, who renewed his mandate. His time heading the central bank is remembered by the turbulent economic situation of the US, which he started his mandate with, when the CPI reached 15%, after what is known as the second petroleum shock. The increased prices of oil, first as a result of the Iranian revolution and then of the Iran-Iraq war, were added to the already complicated situation of the prices which resulted from the first petroleum crisis at the beginning of the 70s and which caused an unprecedented inflationary spiral in the North American economy.

Volcker fought against the increased inflation by raising official interest rates with an aggression never known before, with the conviction that only very high rates would achieve sufficient reduction of consumption and inflation and increase savings in such a way that pricing dynamics would start to decrease. At the start of the 80s he placed the official interest rate over 20% to combat the so-called period of High Inflation. Eventually, he achieved what he was looking for and inflation decreased substantially as a result of this policy. That is, not without significant collateral damage.

The first effect was a very significant impact on employment. The unemployment rate reached the highest point since the great recession of the 30s, exceeding 10% in 1982. The second effect of this monetary policy was of a financial nature and caused a crisis (also unprecedented since the great depression) in the powerful North American savings bank industry, the so-called Savings&Loans (S&L).

The S&L focused its business model on the real estate sector, essentially financing the buying of properties of American families. This financing was granted, fundamentally, to fixed interest rates during the existence of the mortgage. The S&L financed these fixed rate mortgages with the deposits of families and businesses.

The problem is that these deposits were remunerated to the current interest rates at any given time.

With the increase in interest orchestrated by Volcker in the Fed, the cost of financing the S&L was progressively increasing, whilst the return on its assets had become fixed by fixed-rate loans. The consequence, a disproportionate increase of the financial costs regarding the financial income for the savings bank. And, the result, the large majority of the S&L entered into losses and had to be closed or recovered by the public sector. Before the end of Volcker´s mandate, more than 300 S&L had been closed due to poor management which, in banking terms, is known as the *interest rate risk.*

The crisis of the North American S&L led to the emergence of a regulation body and banking practices aimed at, logically, not allowing the incidence to repeat itself and that, within certain limits, if a financial institution financed its variable rate liabilities, it would do so to finance variable rate assets, whilst if it did so by financing at fixed rates, its assets would be primarily at a fixed rate.

But not everyone learnt this lesson. And, also in line with some relaxations of the regulation orchestrated by the Trump Administration a few years ago, one of the most important Californian banks in the business of financing start-ups in the Silicon Valley region (California) entered, at the start of March, into a situation which led to its financial *death.*

The Silicon Valley Bank (SVB) had specialized in providing financial services to the Venture capital industry, seed capital and technological companies in general. At the end of 2022 it had a balance that was characterized by a very significant amount of public bonds and bonds issued by American government agencies. The credit demand from its business clients was not very high, so the bank had invested in these bonds to obtain profitability greater than the cost of its deposits. These bonds paid a fixed coupon throughout their existence and were, therefore, similar to the fixed-rate mortgages of the S&L which we have referred to. On the liabilities side, the SVB essentially had its business clients´ deposits. Its client base, therefore, was not a retail base with small and relatively stable deposits. More than 90% of its deposits were big and highly unstable due to the nature of its clients.

The increase of interest rates on public debt, as a result of the increase in the official rates of the Fed which began at the beginning of last year, had devastating consequences for the SVB: the value of its bonds decreased, so it had significant losses. The clients were afraid to see that the bank was losing money and demanded to withdraw their deposits quickly. The combination of these two dynamics ended with the closure of the bank by the North American authorities during the second week of March.

2. The risks of a financial spiral are very limited…

The closure of the SVB triggered memories of the 2008 financial crisis and concerns that it would cause a similar incidence. Although it is related to the poor management of an entity, the concern was seen to be reenforced by the fall, in this case in Europe, of a reference entity in the business of the global private bank: Credit Suisse (CS). In mid-

March, CS was intervened in by the Swiss authorities not due to problems in the management of interest rate risk, but rather for accumulated losses in some ventures (it lost 6 thousand million dollars in the venture capital fund Archegos) and problems of reputation and internal control of the entity.

The combination of both events triggered the concern and, although they are events specific to the problems of each entity, as a result they caused a “small” tsunami in the financial markets, with all the indicators of financial *stress* launched for days: stock market falls, increase in risk premiums, difficulties in obtaining financing in markets, etc.

A significant consequence of these instances (SVB and CS) is that investors and economic agents began to anticipate, at the end of March, that the financial difficulties could have consequences for the dynamism of the economy in general – withdrawal of consumption, less investment, less growth of international trade. The anticipated weakness of the economy should, then, help the increased levels of inflation observed in these past months to gradually correct themselves and, as a result, the interest rates of central banks would not have to increase as much as had been anticipated before these instances.

As such, in recent weeks, the investors and operators in the financial markets have significantly recalibrated their expectations on interest rates, including anticipating, in some cases, possible cuts in official rates this very year.

The ECB increased half-point rates in its March meeting, despite the financial turmoil, just as it had pre-announced in the previous meeting. And, although most of the ECB members were not opposed to new increases in rates, they demonstrated a tone less stressed than before the problems in the banking system appeared. For their part, the investors, who before expected ECB rates above 4%, now expect that they will not exceed 3.75%.

The Federal Reserve, for its part, increased the official rate by 0.25%, placing it in the range 4.75%-5.00%, the largest registered since 2007. And, although the central bank anticipated that an additional tightening of the monetary policy may be suitable so that inflation shrinks to the objective of 2%, it recognised that it would be attentive to the risks derived from the recent problems in the banking system, in such a way that the investors now only expect, perhaps, a 0.25% increase (more than half a point lower than what was anticipated before March).

The crisis of the two banks which we have referred to has had, therefore, significant effects, because it has slowed down the expectations of increasing the interest rates which existed at the start of the year. But the fundamental elements that determine the current situation are not that different to those which we identified in this Economic Note 3 months ago.

2023 progresses and, progressively, the most negative predictions are becoming clearer despite the effects of inflation on the available income of families, the rise in interest rates and the increase in financial costs.

In Europe, growth continues to be supported by the dynamism of public spending, the maintenance (“anchoring”) of the economic agents´ expectations of inflation in a context where the increase of prices starts to recede (inflation in the euro zone fell by 1.5% to 6.9% in March), the good performance of the job market (unemployment rates remain at relatively low levels), and the weakness of the euro, which helps the dynamism of foreign trade in an environment in which the Chinese economy is recovering with relative strength.

In short, good news cannot be spread whilst inflation remains at its current levels, but the situation is far from what we referred to as “the Epic of Pessimism” in a previous Note.

3. … and, although the economy is doing well, geopolitics are not so good

If the continuation of inflation is a risk that developed economies have going forward - which, hopefully, we are capable of managing collectively -, geopolitics is another risk that we must continue paying attention to. And the news there is less good.

The war in the Ukraine may have disappeared from the front pages, but human tragedy continues, and the conflict continues dragging down the energy products market enormously and affecting business expectations and investment. Certainly, Holy Week seems to have been a successful operation, especially in our country, but in this situation any shift in the events in Kiev may turn global recovery around.

For its part, the French President´s recent journey to China illustrates the potential risks that still persist in relation to Europe´s position in the world (and in Russia´s aggression towards the Ukraine, in particular) and to the elements that should maintain their influence.

Marcon reenforced, in his visit, the commercial ties between France and China. So far, so good, despite the fact that he did so on the same days in which the president of the European Union, Von der Leven, also visited the Asian country with a message much more centered around human rights and the foundations that should sustain the political dimension of the Chinese-European relationship.

The problem is that Macron went further to declare that Europe had to strengthen its strategic autonomy against the United States and commented that Taiwan could be understood as a problem far away from European interests and that, as a result, Europe has no reason to interfere nor to be part of the solution.

The problem, with this argument, just as the French President was quickly reminded from the other side of the Atlantic, is that, if the line of argument is that Taiwan is not Europe´s problem, the argument that the Ukraine is one for the US is difficult to maintain.

Beyond Macron´s divergent message *in situ* with regards to that of Von der Leven, the French President illustrated, one more time, that French international and defence policy seem, at times, to be just that, French and not “European”. And this comes at a particularly delicate moment for the European project, in which consensus and joint efforts play such an important role.

That Macron´s words did not sit well with the US (and with many European countries) seems logical. The problem is that, due to the current political dynamic in that country, it makes them especially and potentially harmful for the bilateral relations with the EU. The indictment against Trump for the scandal of alleged “hush” money payments to an actress and Fox news channel´s tactical recognition of the manipulation of reality, in relation to the re-counting of votes after the 2020 presidential elections, add tension to American society, already very divided since the election of Trump. These events will be, without a doubt, used by “*Trumpism”* to re-generate a dynamic of confrontation in which the possibility of pointing out an external “enemy” can only serve their interests.

he announcement that the TV channel Fox News, property of Rupert Murdoch, will pay almost 800 million dollars (more than 700 million euros) to the creator of the Dominion voting machines for damages and harm, puts an end to the lawsuit that had been initiated by the latter´s accusation of defamation for seconding the false claims of Donald Trump, who blamed his defeat in the 2020 Presidential Elections on the manipulation of the electronic vote.

It is difficult to overemphasize the importance of this news. When one of the main forms of communication in the most developed economy in the world accepts that it falsified information in such critical moments, such as those that took place between November 2020 and January 2021 (with the final assault on the Capital) and that its star presenters, such as Tucker Carlson and Sean Hannity, knowingly and shamelessly lied to the population, one cannot stop questioning the health of our democracy and the respect for such a basic principle as the assumption of responsibility when these types of behaviors present themselves.

Let us link these events to the generation of photographers of a violent detention of Trump in New York, generated by an artificial intelligence program with chilling “realism”. It is impossible not to question how the group of citizens are going to manage the search and discovery of “truthful information” that allows us to have a “precise” vision of reality in times that we have going forward. The quotation marks are not a mistake, but rather the contestation that the exact significance of these words is blurred in this context.

4. Is Spain different?

The Spanish economy seems to have been something far away from these events in recent months. The growth has slowed down, but it hasn't returned to be negative, as some predicted, and the inflation in March decreased to 3.3% (almost 3 points below the previous month), although it is indeed true that the underlying inflation (that which does not take processed food or energy into account, which are more volatile elements) still stands above 7%.

As the unknowns of the beginning of the year have become clearer and clearer, the forecasts for our economy have, at least slightly, been revised. If at the beginning of the year the predicted growth barely touched 1%, it is currently expected that it is closer to 1.5%, with a progressive decline of inflation towards 3%. It is difficult to accept that a few years ago we would have defined "crisis" as a situation in which the Spanish economy would have grown by 1.5%, with an unemployment rate of 12%, inflation at 3% and some interest rates in the vicinity of 3%.

The first quarter of the year has been reasonably good, crowned by a busy Holy Week, in which the tourism sector (which constitutes more than 10% of the GDP and more than 12% in employment terms) has had an excellent performance. Even so, in the next few months, a certain weakness could be observed which would have its basis in the finalization of the savings buffers accumulated during the pandemic by families and the progressive disappearance of companies´ ability to transfer the increase in their costs to prices that we have seen in these past few months.

If politics allows it, the tone for the rest of 2023 should, therefore, be similar to what has been observed up until now. The municipal and autonomous elections in May, and the general elections at the end of the year, will focus the political calendar after a first quarter characterized by the "three reforms": the so-called "Law of only yes means yes", the Law of housing and that of pensions.

The first has caused tension in, but not broken, the government coalition. The other two have good intentions, but it is doubtful whether they will achieve their two fundamental objectives: ensuring a more universal and affordable access to housing, and preserving the sustainability of our public pensions system, respectively.

Concentrating our attention, to conclude this Notice, on the latter because of its short-, medium- and long-term economic implications, it is worth highlighting that the Government presented, and Parliament approved in March, the second part of the reform of the pensions system.

Our pensions system (just like those of the majority of countries in our vicinity) was designed in a context in which life expectancy, once retirement age was reached, was at least one decade less than what we have nowadays. This simple fact already brings to light that the need to increase salaries and control spending is imperative if we want to maintain its future sustainability. And, although they have started to carry out reasonable adjustments in the past few years within the framework of the so-called "Toledo Pact" (which tried, amongst other things, to depoliticize the debate on such an important topic and which affects citizens in such a direct way), the general consensus is that, from not taking additional measures, the pensions system will generate an unmanageable deficit in the coming decades.

The discussion in the area of pensions always ends, logically, in if it is necessary to decrease the costs of the system or if increasing salaries is recommended. The first has a negative effect on the level of pensions. For the second, one must agree on where the additional resources will be obtained from, which is not a trivial matter because ultimately pensions are financed either with what, de facto, is a tax on work (social contributions), or with general taxes that the public sector collects.

The recent reform puts emphasis very markedly on the increase of income by way of (i) a change in the initial pension´s period of calculation; (ii) a gradual increase in the maximum contribution bases; (iii) a surcharge on incomes that exceed the maximum contribution basis and; (iv) a tightening of the so-called Mechanism of Intergenerational Equity.

The increase in incomes that the reform brings about will help to partially close the deficit of the system in the coming years because, amongst other things, the reform substantially increases contributions of the highest pensions in relation to their future evolution (something which goes poorly with the concept that the system is "contributory"). However, the consensus between experts does not seem to point out that this will be the last reform of the pensions system, that is to say, the increase of both the number of members as well as the average pension will continue to put accounts under high pressure in the coming decades.

Of the challenges that those responsible for reforming and making our public pensions systems sustainable have going forward, the recent events in France with Macron´s reform have given a good account.

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