Foreword by the Governor Pablo Hernández de Cos

The Banco de España's *Annual Report* takes stock of the developments in the Spanish economy in 2022 and in 2023 to date, setting them against the global and European context. It goes on to describe and evaluate the economic policies implemented to address the energy crisis and assesses the outlook and the main risks for the coming quarters (Chapter 1). Taking a longer perspective, this report spells out the main structural challenges facing the Spanish economy, placing particular stress on those factors that have hampered convergence with the euro area in recent decades and the structural reforms needed to make up for lost time (Chapter 2).

The report also includes two thematic chapters. The first one reviews the monetary policy response of the European Central Bank (ECB) to the current inflationary episode in the euro area and analyses its transmission to financial conditions, economic activity and inflation (Chapter 3). The second thematic chapter focuses on the response of Spain and the European Union (EU) to the energy crisis and the challenges outstanding in the area of energy, including those relating to import dependence and the green transition (Chapter 4), thus complementing the chapter on the climate challenges facing our economy published in last year's *Annual Report*.

Accordingly, the Annual Report supplements the analysis of the Spanish financial sector carried out by the Banco de España, presented every six months in the Financial Stability Report, the latest edition of which was published in April.

Recent macroeconomic developments

Economic developments in 2022 and in 2023 have been marked by two contrary trends. At the beginning of last year, the lifting of the pandemic-related restrictions triggered a strong recovery in activity. Subsequently, the Russian invasion of Ukraine drove up commodity price increases, which started in 2021, leading to an intensification of inflationary pressures and, in response thereto, monetary policy tightening. As a result, real GDP slowed notably in the second half of the year.

That said, economic activity has been more resilient than initially expected, and in 2023 to date, signs of renewed momentum seem to be discernible. Real GDP growth stood at 5.5% in

2022 as a whole in Spain (3.5% in the euro area), while in 2023 Q1, the Spanish economy grew by 0.5% quarter-on-quarter (0.1% in the euro area). Taking as point of reference the moment before the start of the pandemic, the level of real GDP is still 0.2% lower (2.5% higher in the euro area).

Factors contributing to the economy's resilience appear to have included the reversal of previous supply shocks, in the form of a fall in energy prices on international markets from the summer onwards (the most adverse scenarios for the energy crisis having been dispelled), and the gradual clearing of the bottlenecks in international trade that emerged in 2021, which has led to a gradual slowing of inflation from the autumn. Also, households have extensive cushions of savings built up during the pandemic, the pick-up in demand following COVID-19 has continued to generate positive effects and the transmission of the restrictive turn in monetary policy has still not been completed. All this, against a background in which activity has been supported by the fiscal stimulus provided by the measures deployed by the authorities to mitigate the fallout from the inflationary crisis.

Particularly striking in this period has been the growth in employment, facilitated by wage moderation: the cumulative increase in the number of persons employed since the beginning of the pandemic has been greater than that in activity and hours worked. As regards its composition, growth has been driven by the pick-up in services, particularly in 2022 H1. Conversely, higher energy input prices have weighed on energy-intensive manufacturing sectors. Also, the momentum of exports, which have made a large contribution to GDP growth, has been notable. The recovery in international tourism has been especially striking, although exports of non-tourism services are also proving to be highly expansionary. As a result, despite the sharp rise in energy prices, the contraction in the current account surplus was relatively small in 2022.

As in the rest of the euro area, the strength and persistence of the rise in inflation in Spain, which began in 2021 and intensified in 2022, has been surprising. Inflation was initially driven by the energy component. But it was then passed through to food prices and underlying inflation (i.e. non-energy goods and services) over the course of 2022. Having peaked last summer, inflation began to fall and continues to do so. This decline has essentially been a result of the sharp slowdown in energy prices, and a slight reduction in underlying inflation has been observed only very recently.

The outlook for the coming years

According to the Banco de España's latest projections,[1] the Spanish economy is expected to become more buoyant over the coming quarters. In 2023 as a whole, GDP growth is expected to be significantly slower than in 2022, but the gradual acceleration of activity is expected to allow annual average GDP growth to exceed 2% in 2024 and 2025. Indeed, the latest information shows higher than expected activity growth in the first quarter of 2023. Along with the recent revision to the historic time series, this suggests that real GDP growth this year may exceed the rate of 1.6% predicted in our latest projections. The faster pace of output growth will be helped, among other factors, by the expected easing of inflationary pressures (leading to a recovery of agents' confidence and real income), an end to the disruptions to global production chains and the deployment of the Next Generation EU (NGEU) funds.

However, these projections are subject to very high uncertainty and there are risks that less positive scenarios will materialise. In particular, the possible duration of the war continues to be the main source of risk for Europe. The future course of the world economy is also a cause for concern, in a context of monetary policy tightening worldwide and significant geopolitical risks, compounded by the doubt regarding the impact and persistence of recent financial tensions. On the domestic front, uncertainty remains over how the savings built up by households during the pandemic might contribute to private consumption and the pace at which the NGEU projects will be rolled out.

Likewise, the growth outlook will crucially depend on the projected disinflation actually taking place. Greater persistence of high inflation would slow the recovery and, should it be seen in the euro area as a whole, would lead to a high probability of further tightening of monetary policy and, thus, of financial conditions.

The medium-term challenges and the role of economic policies

A succession of negative shocks in recent years has required decisive action from the various economic policies to mitigate their impact on the economy. Appropriate application of these policies will continue to be crucial over the coming quarters.

1 Macroeconomic projections for the Spanish economy (2023-2025).

From a long-term perspective, it is essential for economic policy action in Spain to focus on addressing the economy's outstanding structural challenges, as borne out by the failure to converge towards euro area per capita income levels in recent decades. Behind this persistent negative gap lie two well-known shortcomings in the Spanish economy: low productivity and a low rate of employment, which have moreover historically been negatively correlated. With this in mind, the big challenge consists in undertaking decisive reforms conducive to convergence with the euro area.

This convergence needs to occur without increasing macro-financial imbalances, to ensure it is sustainable over time. In this respect, since the outbreak of the global financial crisis, the Spanish economy has displayed a pattern of growth that has partly corrected the imbalances built up over the previous upswing.

In particular, there has been intense deleveraging by Spanish households and firms; an increase in the solvency and liquidity of the balance sheets of credit institutions, following the thorough process of balance-sheet clean-up and restructuring and the strengthening of the regulatory framework as a result of the global financial crisis; an improvement in competitiveness (which has enabled a positive current-account balance to be maintained since 2012, even after the outbreak of the pandemic and the energy crisis; and a reduction in the share of construction investment in activity to levels similar to those seen in the euro area as a whole.

However, certain structural vulnerabilities remain, which shape the outlook for economic growth and its sustainability going forward. Notable among them is that arising from the high level of public debt (up by more than 80 percentage points of GDP since the start of the financial crisis), which is also accompanied by a considerable structural budget deficit. This situation amounts to a significant source of vulnerability for the Spanish economy, especially in a context of monetary policy tightening, while it also reduces the fiscal space available to address possible future negative shocks.

In addition, the Banco de España, along with other institutions and analysts, has in recent years highlighted the vulnerabilities stemming from the increase in certain aspects of inequality in Spain, in particular in the area of opportunities. Reversing these trends and mitigating their adverse effects sustainably over time requires public action in diverse spheres, which needs to be stringently evaluated in terms of both equity and efficiency.

In this context, the appropriate use of NGEU funds and the rigorous and ambitious design, implementation and evaluation of the reforms included in the Spanish Recovery, Transformation and Resilience Plan (RTRP) represent an historic opportunity that must not be wasted.

i) Monetary policy: ensuring price stability

In response to the growing inflationary pressures and higher inflation outlook, in late 2021 the ECB began a process of monetary policy tightening to meet its objective of maintaining euro area inflation at 2% over the medium term. This tightening has been the sharpest and fastest in euro area history. There are short-term costs to this process in terms of weaker economic activity, but maintaining price stability is the main contribution that a central bank can make to ensure sound economic growth in the long term.

Looking ahead, euro area inflation is expected to remain at high levels over the rest of 2023, albeit on a declining path that would bring inflation close to our 2% target in the medium term. This decrease would be driven by a combination of factors, including the fading of the effects associated with the economic reopening, previous supply shocks (supply bottlenecks and soaring energy prices) and the depreciation of the euro. It is likely to be furthered by the growing pass-through of the recent drop in energy prices, the exchange rate appreciation and the easing of domestic demand as a result of, among other factors, our monetary policy decisions.

However, this outlook is subject to much uncertainty, in particular regarding the potential duration of the war in Ukraine. Likewise, the financial market tensions, should they persist, could lead to a sharper than expected tightening of credit conditions, thus posing a downside risk to growth prospects and inflation. Conversely, continuation of the recent reversal of past supply shocks could foster confidence and support stronger growth than currently expected. The continued resilience of the labour market might also translate into stronger than expected growth by bolstering confidence and household spending.

In addition, certain factors could delay the return of inflation to the 2% target in the medium term, most notably the possibility that energy price declines will pass through to other goods and services more slowly and to a lesser extent than past increases, the possible emergence of second-round effects via wages or profit margins and the uncertainty over the possible reversal of the fiscal policy measures introduced to mitigate the effects of inflation.

Against this background, we at the ECB Governing Council have emphasised that monetary policy decisions will continue to be based on our assessment of the inflation outlook in light of the incoming economic and financial data, the dynamics of underlying inflation, and the smooth functioning of the monetary policy transmission mechanism. In any event, these decisions must ensure that interest rates will be brought to levels sufficiently restrictive to achieve a return of inflation to our 2% medium-term target and will be kept at those levels for as long as necessary.

Likewise, we have underlined our readiness to respond as and when necessary to maintain financial stability in the euro area, given that, as we underlined in the monetary policy strategy review, this is a prerequisite for ensuring price stability. We have the right toolkit both to provide the required liquidity to the financial sector and to act against possible risks of debt market fragmentation. With regards to the latter, the ECB applies flexibility in reinvestments under the PEPP portfolio as a first line of defence. Were this to prove insufficient, the new Transmission Protection Instrument (TPI) introduced in July 2022 could be activated if necessary to ensure the smooth and effective transmission of monetary policy across the euro area.

ii) Budgetary policy: targeted support for the most vulnerable, compatible with a fiscal consolidation process getting under way this year

Crucially, in the current high inflation environment, the fiscal policy stance must not be incompatible with the tightening of our monetary policy. Hence the recommendation that the public support measures to mitigate the impact of higher inflation on households and firms should be temporary, be closely targeted at the most vulnerable groups – thus avoiding an across-the-board fiscal impulse – and preserve the incentives to consume less energy. Further, these measures should be withdrawn gradually, in step with the decrease in international prices already under way. Otherwise, we run the risk of a sustained fiscal expansion amplifying the inflationary pressures in the medium term, and thus necessitating a more robust monetary policy response.

The broad range of measures deployed in 2022 and 2023 by euro area countries, including Spain, helped to underpin activity and contain inflation in 2022 and are expected to continue to do so in 2023. However, their withdrawal will push up consumer prices over the coming years, particularly in 2024. The bulk of the measures have indeed been designed to be

temporary. However, they have not been sufficiently geared towards the agents most vulnerable to the inflationary shock, and therefore the effects on these agents might have been mitigated at a lower fiscal cost.

In the case of Spain, the general government deficit and public debt remain very high. As a result, a fiscal consolidation plan should be introduced, starting in 2023, to gradually reduce this vulnerability and to recover fiscal space to be able to address potential adverse shocks in the future. This is especially necessary given that inflation helped to reduce the fiscal imbalance in 2022, but its long-term impact on public finances will be less favourable or even negative – since its upward impact on public spending comes at some lag –, and there are some doubts over the extent to which the strong tax revenue growth of recent years will prove temporary.

Further, in the short term, the roll-out of NGEU funds and the structural reforms under the RTRP could more than offset the economic slowdown that might be triggered by the start of the fiscal consolidation process, presenting us with an opportunity that should not be missed.

This process must be grounded on prudent macroeconomic projections, involve all tiers of general government and translate into a medium-term plan detailing the government revenue and expenditure measures to ensure a gradual reduction in the imbalances. This would shore up the sustainability of public finances and bolster the credibility of, and confidence in, economic policies. According to Spain's Stability Programme Update for 2023-2026, the structural deficit will decline by a cumulative 1.2 pp of GDP by 2026 and the primary structural balance by 1.6 pp.

The fiscal consolidation should also be compatible with an improvement in the quality of public finances, boosting their contribution to the economy's potential growth. On the expenditure side, it is essential to bolster efficiency – in line with the recommendations issued by the Independent Authority for Fiscal Responsibility – and to optimise the distribution between items, preserving those that are essential to foster economic growth and equal opportunities, such as spending on education or health care. On the revenue side, a comprehensive review of the tax system is required, in line with some of the guidelines laid down in the White Paper on Tax Reform. In particular, it appears necessary to shift the burden of taxation to consumption, to review the significant cost associated with the tax relief measures, to strengthen and raise green taxes and to deepen the international coordination and harmonisation of the tax system to contend with the growing levels of digitalisation and

globalisation. These actions could be accompanied by compensatory measures to mitigate their potential effects on the most vulnerable groups.

A further consideration to bear in mind when analysing medium and long-term public debt dynamics is the impact of population ageing on public pension spending, not forgetting that this phenomenon will also exert upward pressure on other expenditure items, such as health care and care for the elderly.

In recent years the pension system has undergone a number of reforms, reversing key elements of the 2013 reform and introducing new changes, mainly aimed at shoring up social security revenues and raising the effective retirement age.

Estimating the impact that the various measures approved may have on the system's revenue and expenditure over the coming decades is subject to much uncertainty. In any event, the wide range of estimates available – by the Banco de España and other institutions – suggest that, as a result of the various legislative changes approved since 2021, the Spanish pension system will, in the long term, have to assume greater expenditure obligations that will not be fully offset by the revenues raised. A further uncertainty is the potential adverse impact of higher social security contributions on employment, wages and competitiveness. According to these estimates, in the framework of the new automatic adjustment mechanism, further measures will have to be adopted to shore up the system's financial sustainability. In any event, a transparent, ongoing and thorough assessment of the effects of these reforms is needed, including their impact on intergenerational equity.

iii) An incomes agreement to prevent inflation from becoming entrenched

It is important to remember that much of the high inflation observed in the last two years stems from the surge in commodity prices, which has led to a very significant increase in the price of imported goods relative to exported goods. In other words, there has been what we economists call a deterioration in the terms of trade, which is nothing less than a loss of wealth and well-being, and, moreover, one that is inevitable in the short term.

Since the loss is inevitable, we should seek to distribute it fairly between workers and firms, in order to prevent the inflationary spiral that will occur if both try to unilaterally avoid the loss

and maintain, respectively, the same level of real wages and profit margins. Such a process would exacerbate the negative impact of higher imports on the economy's competitiveness, resulting in employment and output losses.

So far, in 2022 there has been a significant decline in real wages in Spain. At the same time, profit margins have been growing since the beginning of 2021, after falling significantly in 2020, albeit very unevenly across sectors and firms.

Therefore, the feared feedback loop between wages, profit margins and prices has not materialised for the time being. But this does not mean it will not do so in the future. To avoid it, as I have been advocating since autumn 2021, it would be desirable to reach an incomes agreement for an equitable distribution between firms and workers of the loss of real income caused by the rise in imported commodity prices. In this regard, it is very important that the existing preagreement between employers' associations and trade unions, the full details of which are not known at the cut-off date for this report, be translated as soon as possible into guidelines for collective bargaining to avoid the risk of an inflationary spiral.[2] An agreement of this kind would provide a commitment to macroeconomic stability and an environment of confidence, which is fundamental in the current inflationary context with high uncertainty.

iv) An ambitious structural reform agenda that allows for sustainable convergence with Europe

As I stressed above, the great challenge for economic policy in Spain should be to foster convergence with the euro area in terms of income. To achieve this, the focus should be on implementing the necessary reforms to increase productivity and the employment rate. This, together with other specific measures, would also allow our vulnerabilities to be reduced.

In order to improve productivity, actions must be taken on multiple fronts, such as removing constraints on business growth or reallocating resources across sectors and firms. Beyond recent initiatives, such as the Law on business start-ups and growth and the Law on developing the ecosystem of emerging businesses, whose effectiveness will need to be assessed over time, achieving these goals requires, among other measures, a review of the regulatory

2 For a detailed description of the main features of an incomes agreement that would guarantee this objective, see my presentation of the Annual Report 2021 to Parliament of 1 June 2022.

thresholds that discourage business growth, reducing the delay on general government payments (which acts as a brake on financing for small firms), ensuring market unity, bolstering competition and continuing to broaden sources of funding available to firms.

It is also necessary to boost innovation by properly designing public mechanisms to channel funding towards projects that generate positive externalities by fostering synergies between different public and private initiatives, and revising R&D tax incentives. And this without forgetting the need to reinforce confidence in public institutions and promote their modernisation, by encouraging an efficient use of public resources and a culture where public policies are evaluated to ensure their effectiveness is continuously improved.

Raising the employment rate is particularly important against a backdrop of an ageing population and a secular downward trend in hours worked. To this end, the Spanish labour market's institutional framework needs to be adjusted and the human capital improved.

The Spanish labour market has traditionally had a high prevalence of temporary contracts, a wage level that bears little relationship with each firms' productivity and ineffective passive and active employment policies. Since the pandemic, regulatory changes such as the 2021 labour market reform have been introduced which have reduced the temporary employment ratio. However, a full assessment of these changes will need to consider many different aspects and a broader time frame. Likewise, the Employment Law and the changes in unemployment benefits seek to ensure compatibility between protecting the most vulnerable and providing appropriate incentives for labour supply.

In any event, looking ahead, if public employment services' currently very limited role in job mediation is to become more relevant and if their training and labour market insertion work is to be more effective, better professional profiling of the unemployed, rigorous oversight of training and labour market insertion programmes and resource allocation based on the findings of assessments are required. Squaring protection for the more vulnerable groups with appropriate incentives on the labour supply-side calls for greater coordination between the active and passive policies. The capacity of migration policies to effectively smooth any mismatches arising in the Spanish labour market also needs to be continuously monitored.

In terms of human capital, despite the significant improvement in recent decades, the educational level of the Spanish population is below the EU average. This reduces

the economy's potential growth and undermines equality of opportunities, since there is evidence that educational attainment differences are very persistent between generations. Against this backdrop, the level and efficiency of public spending in Spain needs to be analysed in depth and the education and vocational training system needs to be adapted to the new technological and demographic environment. Recent reforms in this area (laws governing education, vocational training and university system) should also be assessed in order to attain these objectives.

Studying the differential impact of public policies on different population groups is also crucial. The Banco de España has increasingly focused its analysis on inequality, both in general terms and in relation to specific aspects, such as, for example, the heterogeneous impact of inflation on households, the increase in their financial vulnerability to interest rate increases, the financial exclusion of certain population groups, the asymmetric exposure to the green transition, the depopulation of certain territories and the persistent differences in per capita income between regions.

Mitigating the adverse effects of the different social vulnerabilities identified requires public measures in a wide range of areas, such as regulation (of the labour and housing markets, among others), taxation, public services (e.g. education and health care) and income policies and transfers. In fact, raising productivity and the employment rate are key elements of any strategy aiming for a sustainable reduction of inequality. And these actions must be rigorously evaluated in terms of both equity and efficiency.

Housing affordability, which has tightened in recent years for both home ownership and rentals, is one domain in which particular vulnerability is observed. For instance, there has been a sharp fall in the owner-occupancy rate, especially among young adults. Accordingly, the increase in rental demand has been concentrated in this group, in lower-income households and in certain geographical areas. This situation, closely related to that of the labour market, has contributed to increasing wealth inequality in Spain. Furthermore, the steeper growth in rents than in labour income has increased the proportion of the population at risk of social exclusion and of households whose ability to spend on other goods and services is constrained.

The insufficient growth of supply to absorb the strong increase in demand appears to lie behind the considerable momentum of rental prices. In response to this, the future Law on the right to housing emphasises the need to increase the supply of rental housing and establishes various price control measures. The latter include measures to limit rental updating and the

possibility of capping rental prices in areas under housing pressure. In this respect, economic studies show that price controls can have adverse effects on rental supply, in terms of both quantity and quality, and that, ultimately, far from making rental housing cheaper, they end up leading to higher price levels. Against this backdrop, it will be essential to rigorously assess the ability of this regulation to effectively achieve its objectives. In particular, we must be watchful for any signs of the above-mentioned adverse effects emerging, so that the regulation can be adapted to stave them off.

v) A reinforced regulatory framework underpinning a healthy banking sector

The financial stress of recent months triggered by the crises at different medium-sized US banks and Credit Suisse has heightened concern worldwide over the risks related to the banking sector's funding costs and liquidity. This episode highlights once again the importance of financial institutions having the necessary funds to absorb unexpected shocks.

In the current setting, euro area and, particularly, Spanish banks are overall highly resilient and have sound capital and liquidity positions. This is the result of the regulatory reform agreed internationally over the last decade, which in the EU has been applied to all banks, irrespective of their size. In the same vein, the pre-emptive role of banking supervision should also be stressed. Even before the recent banking events, certain supervisory priorities had been set within the Single Supervisory Mechanism specifically to mitigate and anticipate the adverse effects of the current macroeconomic context. The supervisors homed in on banks' interest rate risk, the sustainability of their funding plans and analysis of the risks stemming from exposures to the non-bank financial sector.

Moreover, the strong retail focus of Spanish banks' business model, which bolsters their resilience to adverse shocks to wholesale market financing conditions, and their favourable financial performance of late are both notable. Indeed, the Spanish banking sector's return on equity rose considerably in 2022, standing well above the average cost of cost of capital. Spanish banks' balance sheets are also in better shape: the NPL ratio has fallen again and their solvency and liquidity ratios far exceeded the minimum regulatory requirements.

Apart from the foregoing considerations, in a situation in which interest rates have had to be raised swiftly, banks face upside and downside risks to their net interest income, the value of

their financial instrument holdings and their balance sheet credit quality. Banks whose average lending rates have adapted to the new situation faster than their average deposit rates (e.g. those with a greater share of variable-rate loans and/or shorter maturities, and a greater share of retail funding) are seeing a substantial improvement in their net interest income, which has boosted their profitability. Conversely, the value of fixed-income financial exposures (e.g. bonds, especially those with longer maturities) has declined. Additional upward adjustments to banks' funding costs and a deterioration in credit risk quality will also be more likely the longer the high-interest rate period continues. How different banks and financial systems position themselves against these risks, which has become an investor focal point, will determine how resilient they are.

In this regard, amid such high uncertainty, including that surrounding the degree of monetary policy tightening, Spanish banks must implement a prudent provisioning and capital policy. A policy that earmarks part of the higher earnings they are currently generating to further bolster the sector's resilience would thus put it in a better position to absorb any potential losses should the worst risk scenarios materialise.

In addition, a smoother-functioning euro area with improved governance would contribute hugely to making the European financial system less vulnerable. Specifically, the banking union needs to be completed through the creation of a fully mutualised European deposit insurance scheme. Any agreement on the creation of such a scheme would boost the confidence of citizens and the markets and contribute to increased risk-sharing in the euro area and, thus, to reducing potential episodes of fragmentation. It would also help to align financial responsibility with the banking supervision and resolution decision-making mechanisms, which are already centralised.

Recent events must also be analysed in depth from a global regulatory and supervisory perspective. The Federal Reserve System has already published its review of the reasons behind events in the United States. We will also be able to draw some lessons from our analysis of recent developments that has just got under way at the Financial Stability Committee and the Basel Committee on Banking Supervision. These exercises will allow us to fine-tune the regulations so that they can be continuously adapted in response to changing circumstances. We must also not forget that the final link of the regulatory reform (Basel III) is yet to be transposed into EU law, which must be done completely and consistently so as to remedy the pending shortcomings, in particular in the definition of banks' risk-weighted assets.

Lastly, it must be borne in mind that the short and medium-term challenges posed by the recent period of extraordinary crises do not make tackling the banking sector's structural challenges, such as those linked to the management of climate-related risks, digitalisation and growing competition from technology firms, any less urgent.

vi) More Europe to deal with common challenges

The war in Ukraine has thrown into relief the extraordinary vulnerabilities posed by the particular energy framework of Spain and the rest of the EU. The existing energy mix (in which fossil fuels account for almost three-quarters of the energy consumed), the considerable import dependencies (as we import virtually all of these fuels) and the insufficient energy interconnection infrastructure within the EU (which is particularly incomplete in the electricity and natural gas segments) have all been conducive to the European economies being hit particularly hard by an adverse shock such as that triggered by the war in Ukraine.

Exposure to these vulnerabilities varies considerably across EU Member States. Yet none of them are immune to these unfavourable effects. The considerable size of the challenge and the fact that it is a common shock underscore the importance of a joint response, like in the case of the pandemic. In short, the response to the war in Ukraine must, once again, be more Europe. Indeed, the response to the crisis has included numerous pan-European components that have supplemented the national authorities' measures. This joint response and the notable adaptability that the EU economies have shown has staved off potentially highly disruptive scenarios.

However, correcting the existing structural deficiencies will require the large-scale roll-out of renewable energy sources, further energy efficiency improvements and greater interconnection infrastructure development over the coming decades. Some of the foundations that should underpin this transformation have already been laid, such as the different European Green Deal initiatives and the NGEU and REPowerEU programmes. Despite the challenges that it poses, the renewables drive could also represent a great opportunity for Spain, as it has the second highest onshore wind power generation potential and the highest solar power generation potential in the EU. Spain also has firms that are global leaders in these sectors.

Nevertheless, achieving the highly ambitious energy and climate goals remains a huge challenge, particularly in terms of financing and technological development. This process will

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also trigger a substantial increase in demand for some commodities (such as rare earths) that are scarce in the EU, which could give rise to new import dependencies on third countries.

Consequently, it is key that European policies continue to provide a joint response to these challenges, which must be agile, provide certainty and ensure that the green transition does not lead to a structural loss of competitiveness for the European productive system. Specifically, with regard to financing, the volume of funds required to undertake the investments associated with the energy and green transition far exceeds the amounts envisaged in the current European programmes and the possibilities of many of the Member States. Therefore, more determined headway will need to be made in public-private cooperation and in the common public funding of these public goods for the EU; for example, by establishing a permanent European fiscal capacity.

In addition, the challenges facing the euro area call for far-reaching reforms to its institutional framework that enhance its functioning. Spain's presidency of the EU in the second half of 2023 is a good opportunity to push these reforms forward.

First, the review of the Stability and Growth Pact must be sped up. A fiscal rule framework that strengthens the sustainability of public finances is needed to ensure macroeconomic stability and the smooth functioning of the euro area. In this respect, Europe's current institutional infrastructure has many shortcomings in this area, and the repeated attempts to address them have resulted in a complex and procyclical set of rules that has failed to prevent the build-up of fiscal and macroeconomic imbalances and does not provide many incentives for compliance.

The European Commission has recently proposed an overhaul of the fiscal rules, the central feature of which are the multi-year budgetary plans to be agreed on with the Member States, which seek primarily to ensure that public debt-to-GDP ratios are put on a downward path or stay at prudent levels. These fiscal commitments would be implemented via an expenditure rule. Meanwhile, the fiscal adjustment paths could be extended where structural reforms and investments that positively impact potential growth and improve debt sustainability are undertaken.

This proposal has several positive aspects worth noting: the debate now centres on debt sustainability; an expenditure rule is put forward as a key adjustment mechanism (given that expenditure is the main variable under the control of the fiscal authorities); the way reforms

and investment and the pace of fiscal adjustment interact is factored in; and allowance is made for greater cross-country heterogeneity. However, a clear system of incentives should also be set in place to remedy the procyclical behaviour of public finances and encourage faster fiscal consolidation during boom times. Moreover, this proposal may not be the most effective way to simplify the current fiscal rules, since analysing debt sustainability is notably difficult in practice.

In any event, the fiscal rules notwithstanding, there is considerable scope for continuing to strengthen Europe's institutional framework and economic governance. In particular, it would be a good idea to create a permanent central fiscal capacity, perhaps constituted around a European unemployment insurance system, as well as a common financing instrument that gives continuity to the NGEU programme. This is essential in order to reduce the risk that some of the investment that is key to digitalisation, the fight against climate change and the EU's Open Strategic Autonomy could fall by the wayside. All of this without forgetting the considerable progress still needed to complete the banking union and the capital markets union.

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In short, ambitious, lasting economic policies will be needed if the challenges facing the Spanish economy in the years ahead are to be addressed decisively. Spain is due for a number of (local, regional and general) elections in the coming months, opening the way for a far-reaching debate on these challenges. A minimum consensus should ultimately emerge on the policies best suited to tackling them, thus ensuring that such policies are durable (a key factor if they are to be successful). Our ability to ensure lasting improvements to the well-being of the general public and real convergence with our European partners will largely depend on this.

Lastly, it should be stressed that, to design and properly implement a host of sweeping structural reforms, it is particularly important that assessment of public policies become the norm and that the related findings be factored into decision-making by the public authorities.[3] Moreover, an assessment culture requires the right data. Without quality, timely and sufficiently granular data, a proper assessment is impossible. In their day-to-day activities government units amass a vast amount of information, which, once processed and matched, can rapidly

3 December 2022 saw the enactment of Law 27/2022 of 20 December 2022 institutionalising the evaluation of central government public policies.

enhance diagnostic and assessment capacities, particularly if made available to the research community. All government units should set to work on this without delay.[4]

In a democratic society, these assessments have a dual (political and technical) role to play. In the political sphere, evaluating the design and effects of public policies should foster transparency regarding policymakers' actions and their outcomes. This facilitates accountability and democratic oversight by Parliament and citizens. It also fulfils a technical function, strengthening the decision-making process by providing it with valuable information to enhance its effectiveness and efficiency. Therefore, when "evidence-based policies" are promoted, this is both a technical argument in favour of effectiveness and a political statement in favour of citizens' and their representatives' democratic oversight of political power.

The Banco de España's *Annual Report* seeks precisely to contribute to a thorough diagnosis of the challenges facing the economy and to help assess the different economic policy tools available to address such challenges.

Pablo Hernández de Cos

Governor of the Banco de España

Foreword to the *Annual Report 2022.*

10 May 2023.

4 The data laboratory recently launched by the Banco de España (BELab) is a good example of this service to society, since it makes the microdata from many of our main databases available to researchers. The same can be said of the recent agreement between the National Statistics Institute, the Tax Agency, the Social Security System and the Banco de España for the joint design of a collaborative data system to which researchers will have access, provided that the information is to be used for scientific purposes in the public interest.