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## Interview with the Governor published in ABC*

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* English translation from the original in Spanish

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**Question: Some months ago the world faced grave uncertainty and poor economic figures; there was even talk of a more-than-likely recession. That risk now seems to be fading. Are there grounds for optimism?**

Answer: Some of the supply shocks adversely affecting our economies have abated somewhat in recent months: the global supply chain bottlenecks have cleared appreciably and oil and gas prices have eased significantly since the summer. All this has taken place against the backdrop of favourable labour market developments and a mild winter that has facilitated the build-up of gas reserves, during which some households were able to make use of savings accumulated during the pandemic and economic policy support was maintained. The upshot has been a more resilient economy. But we must remain cautious. The outlook continues to point to a significant slowdown in growth in 2023 compared with the previous year and extraordinary uncertainty remains.

**Q: Spain is the only EU country that is yet to recover its pre-pandemic GDP. Where has it gone wrong?**

A: The last three years have been very challenging both for Europe and the wider world. The shocks have been similar in nature everywhere (pandemic, energy crisis, production and trade bottlenecks), but their effects have been highly uneven across countries. Some of these factors have affected Spain comparatively more and others comparatively less. But the pronounced adverse effects of the pandemic probably had the largest bearing on the country, above all due to our economic specialisation in the hardest hit sectors. Specifically, in tourism services, which are now recovering strongly.

**Q: Perhaps the best news over the last two years has come from the labour market. However, there are now serious signs of job creation slowing. Should we be worried?**

A: The fact is that the labour market in Spain and in other developed countries is showing strong resilience, although a slowdown might still be expected in line with economic activity. Indeed, the euro area unemployment rate is at an all-time low. In Spain, the widespread use of furlough schemes during the pandemic and wage restraint appear to be significant factors behind this robust performance, which is something to keep in mind in the future. Despite

the recent encouraging developments, reducing unemployment must remain a priority of the highest order for Spain.

**Q: The labour market has performed well during this period, albeit with some controversy over the new permanent seasonal employment contract...**

A: The labour reform abolished certain types of contracts and fostered the use of others, such as the permanent seasonal employment contract. A proportional increase in these was therefore to be expected, in step with the desired outcome of a reduction in temporary contracts, which did in fact take place. The key now is to assess whether or not these changes have increased the incentives for workers to undergo training and gain experience – and ultimately whether they will drive up productivity and wages – as well as to examine their impact on employment. This analysis requires time and, crucially, data.

**Q: Is a lack of data transparency concealing the number of economically inactive people in each period?**

A: As I have emphasised many times, it is essential that we, as data-generating public institutions, provide analysts and academics with information of the highest possible quality and in sufficient detail. This is the only way to further the evidence-based approach to public policymaking, which is key to improving its effectiveness, efficiency and accountability.

**Q: Let's talk about inflation. What needs to be done to get back to the 2% target?**

A: The responsibility for achieving price stability in the euro area lies with the ECB Governing Council, which explains the monetary policy decisions that we have been adopting. Now we need to stay the course. However, it is also important that fiscal policy move in step, focusing on the most vulnerable groups and avoiding an across-the-board fiscal impulse that could add to inflationary pressures. Measures should be designed to avoid any significant skewing of price signals – providing an incentive for the economy to adapt to the energy shock – and should be temporary so as not to further increase government debt or the structural budget deficit. However, going beyond demand-side policies, offsetting the effects of the current supply-side shock calls for policies that boost the growth of productivity, employment and potential GDP. Common European policies to strengthen the single market, with joint funding arrangements, are likewise key. It is also my view that an incomes agreement should be reached, whereby profit margins and salaries share the burden for the inevitable loss of income entailed in the higher cost of imported commodities, thus averting an inflationary spiral.

**Q: With inflation in decline (albeit still high), does an incomes agreement still make sense?**

A: Projections point to inflation easing further but remaining above the 2% target. In this setting, I believe a burden-sharing agreement between firms and workers, reached under the framework of social dialogue, remains essential, with all parties assuming part of the loss of real income and with explicit multi-year commitments regarding wage increases and profit margins. The agreement should be across the board but allow for distinctions between the different sectors and agents, while avoiding any automatic indexation to past inflation.

It should also be strengthened by eschewing the widespread use of automatic indexation clauses in public spending.

**Q: And would it apply to pensioners and public sector employees?**

A: Public sector employees already receive below-inflation wage increases. In the case of pensioners, so as to reinforce the commitment to stability, in the short term I think they could share the burden of the inevitable loss of national income prompted by higher imported energy prices – with the obvious exception of the most vulnerable. This short-term response would be independent of the structural decision adopted by Parliament to re-index pensions to inflation.

**Q: How will linking pensions to CPI and eliminating the sustainability factor affect the system?**

A: It is important to point out that the demographic trends expected over the coming years will exert pressure on public spending, and on pension expenditure in particular. The decision to link pensions to inflation and repeal the sustainability factor introduced with the 2013 reforms means increasing pension expenditure as a percentage of GDP by between 3.2 pp and 3.5 pp in the period 2019-2050. Compensatory measures are therefore needed. The higher social security contributions associated with the new intergenerational equity mechanism and the new incentives for delaying retirement, among other measures, have been introduced precisely for that purpose. However, our analysis suggests that the measures approved thus far are insufficient. It is therefore essential that the second stage of the reform, which is currently under debate, fully cover the still-existing shortfall and thus ensure the system's long-term financial sustainability.

**Q: Let's talk about that second part of the reform. The Government claims that removing the cap on the social security contribution base and extending the calculation period for contributory pensions will have a neutral impact on new pensions. The Banco de España is warning that the opposite is true...**

A: Increasing the number of years used as the basis for pension calculations would strengthen the implementation of the contributory principle in the system, i.e. the idea that benefits received are tied to contributions made. In terms of its effects, in a recent paper, our economists studied the potential impact of an increase from 25 to 35 years. It shows that such a rise would lead to a drop in the average starting pension. But, if alongside this increase to 35, the least favourable years were eliminated from the calculation, that drop could be cushioned and pension heterogeneity across individuals reduced. For instance, taking the most favourable 29 years of the 35 years before retirement would lead to an average pension similar to one calculated using the 25 years prior to retirement and would, on average, lead to an increase in initial benefit amounts for lower pensions. Of course, different combinations of the regulatory base calculation periods and least favourable years being disregarded from calculations, which the Government appears to be considering, will yield different impacts.

**Q: How will raising the maximum bases affect the system?**

A: The key here is the link between maximum base and maximum pension benefits. An increase in the maximum bases alongside an equivalent increase in maximum pension benefits would uphold the contribution principle in the system but would only barely improve its financial equilibrium in the medium term. In order to improve this equilibrium, the maximum base must rise more steeply than the maximum pension benefit, which, of course, lowers the pension replacement rate for the affected cohort and undermines the principle of contribution.

**Q: What might happen if the budget deficit and government debt are not contained?**

A: Spain has high levels of debt and structural budget deficit relative to its GDP. These represent a significant source of vulnerability and reduce the fiscal space available in the event of adverse shocks. As a result, a programme of fiscal consolidation in the medium term is needed, detailing how to gradually moderate these imbalances – and this process must begin in 2023. By this, I mean that we must see a reduction in the structural budget deficit this year. This is especially true in the current environment of tightening monetary policy. This process can begin right away without fiscal policy ceasing to have a positive aggregate impact on economic growth, provided that NextGenerationEU funds are put to good use.

**Q: As long as European funds are put to good use...**

A: Essentially, if European funds are used to finance the projects that best bring together public and private investment and – and this is very important – they are accompanied by the right structural reforms, they could materially boost the potential growth rate. These reforms and the deployment of these funds should significantly aid in the reallocation of resources among sectors and firms that is needed to adapt to the energy shock. Getting this right will strengthen the perception in Europe that pressing ahead towards ever closer union is both expedient and necessary, for example, by creating a permanent fiscal stability mechanism, which is what the euro area needs.

**Q: In times of prudence, as we are seeing now, what should be done with bank dividends?**

A: Banks need to use this short-term increase in profits to bolster, not just maintain, their resilience. Right now, this means prudent dividend and provisioning policies.

**Q: We now have three new taxes: on wealth, banks and energy firms. What impact will they have in Spain?**

A: We don't have an impact assessment yet. In any case, I would like to emphasise that I believe there is widespread consensus regarding the need to completely overhaul the tax system to improve its revenue-raising capacity and efficiency. This should go hand-in-hand with a comprehensive review of public spending. These steps are a fundamental part of the process of fiscal consolidation that I referred to earlier. Other European countries can serve as a benchmark here. Such comparisons reveal that less tax is collected in Spain, on

average, than in other countries. This is not so much down to lower marginal tax rates, but rather the result of deductions, rebates, and the like, which ultimately lower the average effective tax rates. In terms of the breakdown of these taxes, Spain fundamentally collects less through consumption and green taxes. This could be a good starting point for the overhaul, which would, of course, take into account the desired redistribution criteria. Lastly, it's very important to account for the fact that the Spanish economy is profoundly integrated into the global economy, which means that the revenue-raising capacity of certain taxes is highly dependent on the degree of fiscal coordination at an international level. That is why the international taxation agreements reached at OECD/G20 meetings and at the EU level in terms of corporate taxation and taxes on digital activities are so important. This is the only way to prevent the introduction of certain taxes leading to competitive handicaps that ultimately depress growth and revenue collection.

**Q: The last ECB meeting saw a decision to raise interest rates another half point. Where is the ceiling for these hikes? Is there a ballpark figure?**

A: Interest rates will rise until we reach a level that ensures a return of inflation to the target of 2% in the medium term. Where is that level? The current uncertainty is so extreme that it really is impossible to give an exact number. However, with the information we have right now, to achieve our goal, we think it will be necessary to continue raising interest rates significantly in future meetings. Once we get there, we will have to hold at that "terminal level" for some time. The key takeaway is that there is still some way to go.

**Q: Are defaults a possibility in the banking sector?**

A: Rising interest rates are undoubtedly raising the cost of borrowing for households and firms, whose ability to pay is eroded at the same time as their income – in both nominal and real terms due to inflation – declines. Having said that, the scale of the impact will depend on the degree of economic slowdown, the persistence of inflation and for how long monetary policy tightening is needed, alongside other factors. From the financial stability standpoint, based on our regular stress testing, the core message is that the aggregate solvency of the banking sector should remain acceptable even in adverse scenarios, albeit with some difference in outcomes across the banking industry. Let's not forget that this resilience is largely down to the implementation of regulatory reforms around the world and, in the case of Spain, the restructuring of the past decade.

**Q: Would it not make sense for banks to go back to paying interest on deposits?**

A: What we're seeing is that interest on deposits has barely risen and that monetary market rates are being passed through to the cost of debt for households and firms more slowly than in the past. The former is down to the fact that we started with negative interest rates, which, to a large extent, had not been passed through to deposits, as well as a context of ample liquidity and high loan-to-deposit ratios in the banking system. Nevertheless, we do expect both borrowing and deposit costs to be passed through more and more. In the meantime, savers are already making use of alternative instruments to improve the returns on their savings.