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Appearance before the Parliamentary Economic Affairs and Digital Transformation Committee: presentation of the Annual Report 2020 of the Banco de España

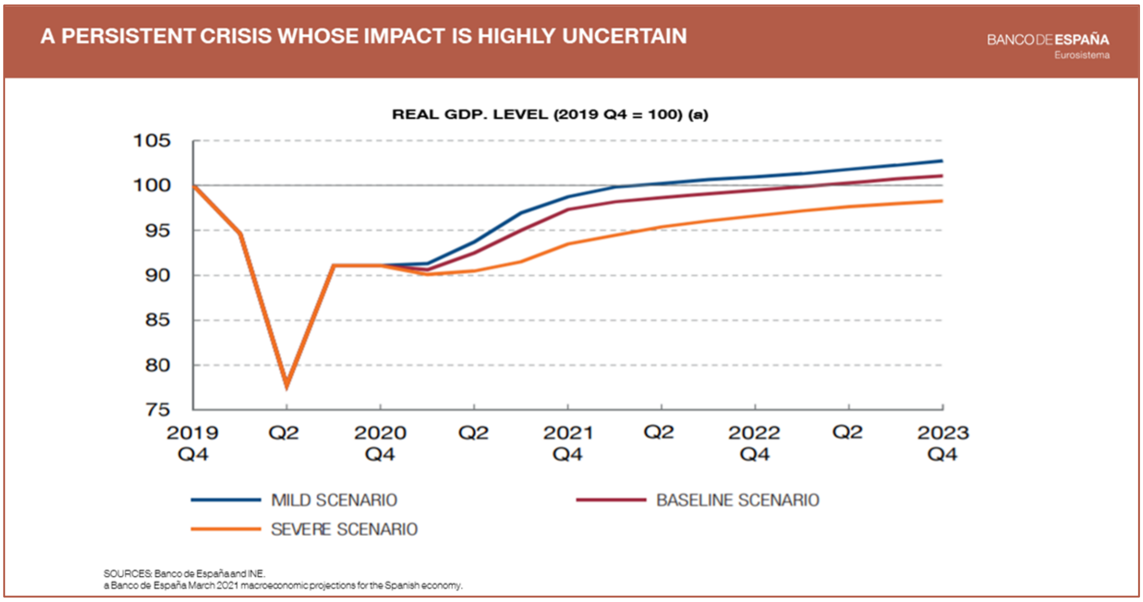
Pablo Hernández de Cos
Governor

Mr. Chairman, ladies and gentlemen,

I appear before this Committee to present the *Annual Report 2020* of the Banco de España. As usual, the Report reviews the developments, outlook and challenges our economy faces, along with our economic policy recommendations. I would also like to share with you the key messages from our latest *Financial Stability Report,* in particular those associated with the banking sector.

In my address I shall first diagnose the economic situation. Next, I shall assess the economic policy response during the crisis. I shall then set out the main economic policy measures which, in the Banco España's judgement, it would be desirable to take into consideration to promote recovery and raise, in turn, growth potential. Finally, I shall address the situation of and the challenges to the banking system.

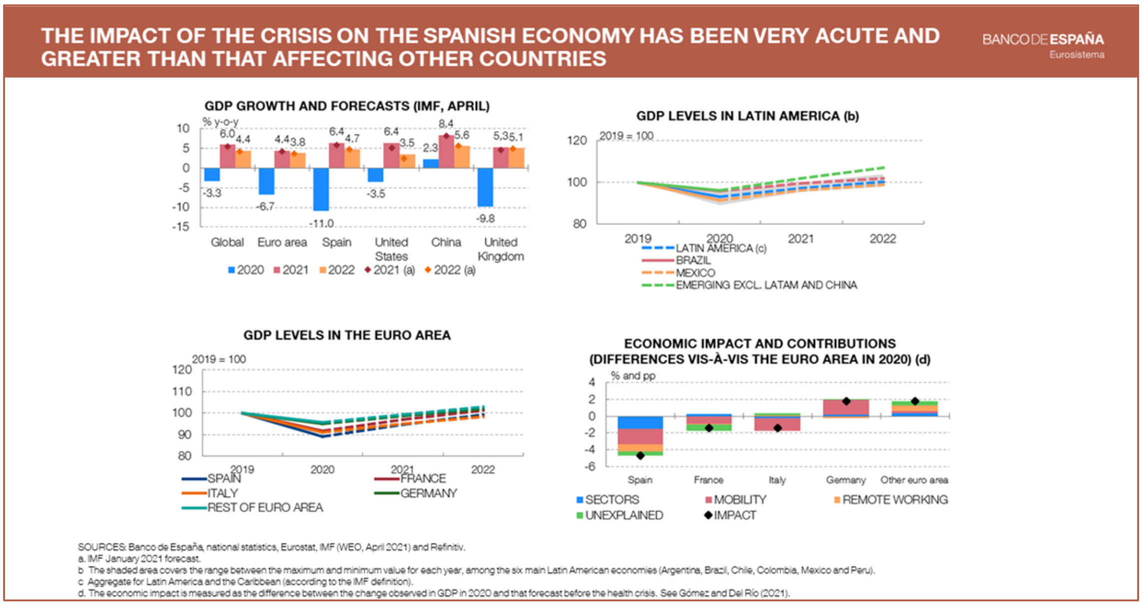
1. Diagnosis of the economic situation



After a year marked by the enormous cost of the pandemic both in human lives and in economic terms, the *Annual Report* presents a setting characterised by the turnaround in expectations prompted by the progressive roll-out of vaccines to the public. This allows us to glimpse a robust and global economic recovery in the coming quarters.

The restrictions on mobility have now been eased significantly in those countries in which the process is most advanced, such as China, the United Kingdom and United States. And this has made for a more favourable trend in their indicators of economic activity. Spain and the other euro area members are less advanced in the vaccine roll-out. But the acceleration in recent weeks suggests that they will move onto a path of recovery in this second quarter, and that this recovery may gather pace in the second half of the year as the restrictions on activity are progressively lifted.

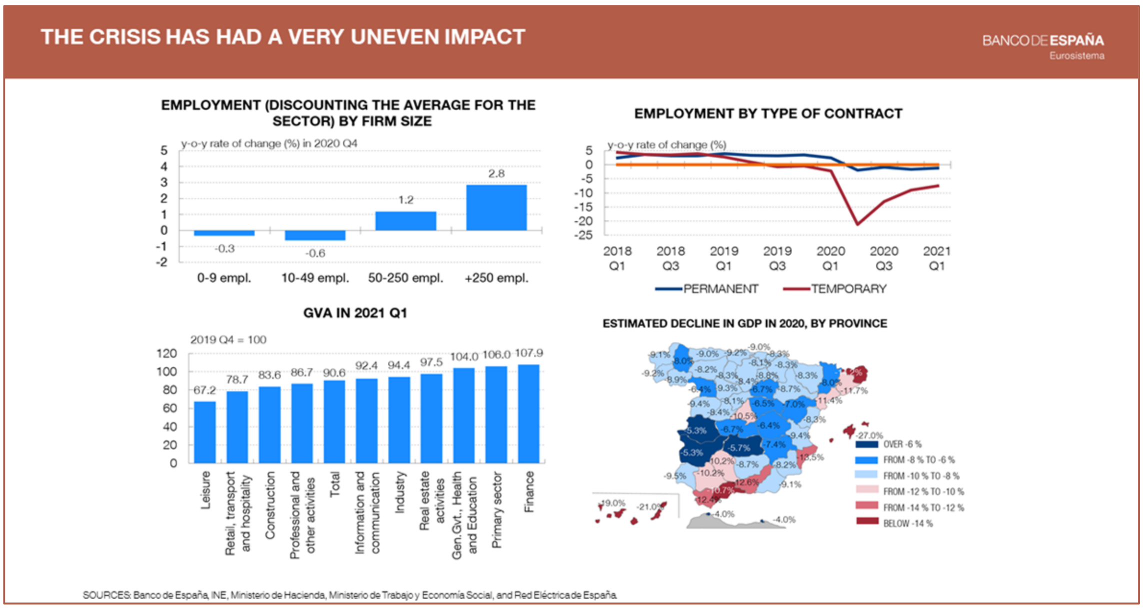
These are the developments set out in the baseline scenario of the Banco de España's macroeconomic projections last March. Thus, GDP is expected to grow by 6% in 2021. More robust activity as from the summer will give rise to a carry-over effect in 2022 which, combined with the foreseeable impact of the Next Generation EU (NGEU) funds, would take GDP growth in 2022 to 5.3%, easing to 1.7% in 2023.



This recovery should be set against an impact of the crisis on the Spanish economy that has been very acute and greater than that affecting other developed countries.

Indeed, the effects are proving very persistent. At the end of 2021 Q1, GDP was still 9.4 percentage points (pp) below its pre-crisis level, and the unemployment rate stood at 16% in Q1 (21.3% if we were to add still-furloughed workers and the self-employed whose activity has been suspended).

Further, the effects of the pandemic may last several years. Under our baseline scenario, we will not recoup the pre-pandemic level of activity in Spain until 2023, while this would be 2022 for the euro area as a whole.



Moreover, the impact of the crisis is proving very uneven. In terms of sectors, it has been particularly concentrated in hospitality, leisure, retail and transport, whose gross value added stood in Q1 more than 20 pp below the pre-pandemic level. By region, we have seen a bigger fall in the island and Mediterranean coastal provinces, with declines in their output exceeding 20% in 2020. As to groups of workers, young, temporary and low-income employees have been especially affected; in particular, the youth unemployment rate was over 30% in Q1. With regard to firms, the smallest ones saw the biggest fall-off in turnover, of around 20%.

THERE ARE UNCERTAINTIES CONDITIONING THE MATERIALISATION AND INTENSITY OF THE RECOVERY

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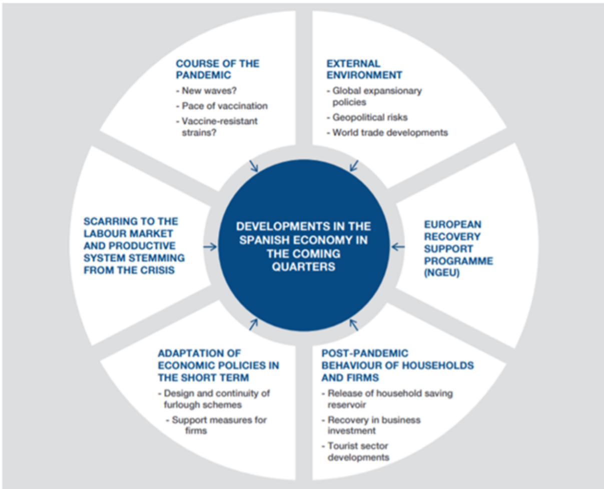

SOURCE: Banco de España.

Different factors of uncertainty remain in place, conditioning the materialisation and intensity of the recovery.

Recovery will first depend on the course of the pandemic, which includes the speed at which vaccines are rolled out and their effectiveness in the face of potential new strains of the virus. Our baseline scenario assumes that the widespread vaccine roll-out will see restrictions disappear in the final stretch of the year.

Second, there are doubts over the pace of recovery of tourism, which will be crucial for Spain given the high share of the sector in the economy (12.4%) and, in particular, the high share of international tourism in total tourist spending (60.2%). Under the baseline scenario we assume these flows will not substantially normalise until 2022.

Third, the intensity of the recovery will depend on the use households make of the saving they have built up during the pandemic, which, in 2020, was almost 6 pp of GDP higher than the average for the five previous years. In fact, on Banco de España estimates, forced saving might have amounted to 2.5% of GDP up to 2020 Q3.

A portion of this saving will be earmarked for consumption, infusing the recovery with momentum. By way of example, consumption in China has already regained pre-pandemic levels. However, some factors might restrict this normalisation. On one hand, a portion of unmet consumption during the pandemic is attributable to spending on services which, generally, is not deferrable. On the other, households might decide to maintain a high level of precautionary saving, or save in expectation of tax rises in response to the increase in public debt. That higher-income households – which tend to consume a lower proportion of their income – should most have contributed to this increase in saving might also limit this effect. Our baseline scenario assumes that the saving rate will progressively fall, but in 2023 it would still be above its pre-pandemic level.

Fourth, there is uncertainty over the damage to the productive system. The number of Social Security-registered firms declined by 3.7% from February 2020 to March 2021, a figure on a par with that of the 2012 crisis, despite the fact that the fall in activity was much steeper last year. Behind this reduction is the decline in the number of start-ups, and not a rise in closures, which might be attributable to the support measures adopted, among which the moratorium on insolvency proceedings.

But future developments are uncertain. Banco de España estimates show that the proportion of firms at risk of becoming non-viable has increased by between 2-3 pp. And the percentage of firms which, while being viable, would face debt problems, might increase by 3-5 pp. That said, our baseline scenario assumes a moderate destruction of the productive system.

Fifth, there are doubts about the distribution over time and the use of the NGEU programme's funds. The average historical multiplier of European Structural and Investment Funds would be around 1. Yet the multipliers associated with these funds depend on the specific end-use and also on the flexibility of the product and factor markets (lower in those countries with greater rigidities). Accordingly, their economic impact will depend both on the projects selected and on their being accompanied by reforms that lessen regulatory rigidity. Our baseline scenario rests on a take-up in line with past evidence and multipliers around unity. Specifically, the projections include an impact of 1% on GDP in 2021, which would climb to 1.9% in 2022.

Finally, the intensity and persistence of the recovery will hinge on the application of appropriate economic policies. I shall return to this matter later.

Reflecting this uncertainty, our baseline scenario is accompanied by two additional scenarios, which offer GDP growth in 2021 of 3.2% under the gloomiest assumptions and of 7.5% under the most optimistic ones.

2. Lessons for economic policy after a year of crisis

The past years' experience allows us to draw some – albeit preliminary – lessons that may be relevant with a view to tackling crisis management in the coming quarters and also from a medium and long-term perspective.

LESSONS FOR ECONOMIC POLICY AFTER A YEAR OF FIGHTING AGAINST THE CRISIS

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1. Speed and forcefulness of the response
2. Comprehensiveness of the response
3. Flexibility and adaptability to the course of the pandemic
4. Complementarity of the different authorities' measures
5. Internationally coordinated action is mandatory
6. The importance of constantly maintaining a balanced and resilient economic position:
    - In the banking sector
    - In the financial position of households and firms
    - In public finances

I should first stress the importance of the speed and forcefulness of this response. The abrupt shock caused by the pandemic has seen an unprecedented economic policy response that has eased costs in the short run, prevented even more extreme and adverse scenarios, and will probably reduce medium and long-term damage.

The International Monetary Fund estimates that the decline in global activity in 2020 could have been three times higher had the measures not been applied. And the countries in which the response has been most intense have tended to undergo less pronounced recessions.

The ECB's reaction has been very forceful: the pandemic emergency purchase programme (PEPP) allowed for asset purchases equivalent to 6.7% of euro area GDP in 2020. And so too the fiscal policy response: the budget deficit increased by more than 6.5 pp of GDP in the euro area, which includes the impact of the discretionary measures and the automatic stabilisers.

Second, the comprehensiveness of the response has been crucial. It has enabled a good portion of the transmission channels of a crisis with very specific characteristics to be covered, affecting both the supply and demand sides.

Monetary policy has covered the main euro area channels of financing. Budgetary policy has focused on mitigating the effects of the crisis on households and firms. And prudential financial policy has provided for enhanced solvency at financial institutions and the granting of solvent credit.

Third, the adaptability of economic policy has been very notable, enabling it to accommodate the course of the pandemic and its uneven effects.

The successive extensions of the support measures for the incomes of the households and firms most affected are a clear display of this flexibility. So too are the different time extensions of the PEPP. As for its design, it has enabled asset purchases to be concentrated in the most crucial months and in those countries which, at each point in time, have been enduring greater financial stress. That has allowed favourable financing conditions to be maintained for all agents in all countries.

Fourth, we should stress the role played by the high complementarity of the measures applied by the different authorities (monetary, fiscal and financial alike), each in fulfilment of their respective mandates.

Monetary policy decisions have been singularly significant in this respect, given that they have provided the fiscal authorities with room for manoeuvre. In 2020 net purchases under the PEPP were for an amount equivalent to more than 90% of the euro area countries' net public financing needs (and almost 30% of gross needs). This has been particularly important in countries such as Spain, which has been especially affected by the crisis and had high budget deficit and public debt levels to start with. The ECB's action is helping prevent an increase in financing costs, which would have restricted the fiscal authorities' capacity to support the economy.

The complementarity of the ECB's measures and those adopted both by national governments and by prudential authorities has also been pivotal for maintaining the banking sector's solvency and smoothing the flow of financing to the economy.

Fifth, the crisis has demonstrated that, in a highly globalised environment, internationally coordinated action is mandatory. And this is particularly the case in Europe, given our high degree of integration. On this occasion, we have seen a genuinely common European response, in which the creation of the NGEU fund stands out. This fund introduces key – and in some respects unprecedented – elements for sharing the effort behind the economic recovery, such as the large-scale issuance of supranational European public debt to finance reforms and investment in the Member States.

One final and necessary reflection is that this crisis has once again highlighted the importance of constantly maintaining a balanced and resilient economic position. Economic shocks can have very different sources. In this case, a completely unexpected factor unrelated to productive activity was involved. But its effects depend on our starting position. In this respect, the improvements in the solvency of the banking sector and the financial position of households and firms, following the deleveraging of the past decade in Spain, have helped us better weather the crisis. Conversely, our initial structural budget deficit and public debt have influenced our responsiveness to the crisis and caused its impact to give rise to a significant increase in our economy's vulnerability.

3. An economic policy for recovery

The expectations of recovery are real, but its speed and scope are subject to high uncertainty and depend on economic policy action. Against this backdrop, it is crucial to incorporate the lessons of the crisis into crisis management in the coming quarters. In particular, the management of short-term challenges must be simultaneously combined with long-term ones that the crisis has accentuated.

Specifically, the economic policy response must combine three objectives: i) maintaining support until the recovery is entrenched; ii) smoothing structural adjustments caused by the pandemic; and iii) resolutely tackling the structural problems that restrict our growth capacity.

And this is applicable to all economic policies, both globally and Europe-wide, and domestically.

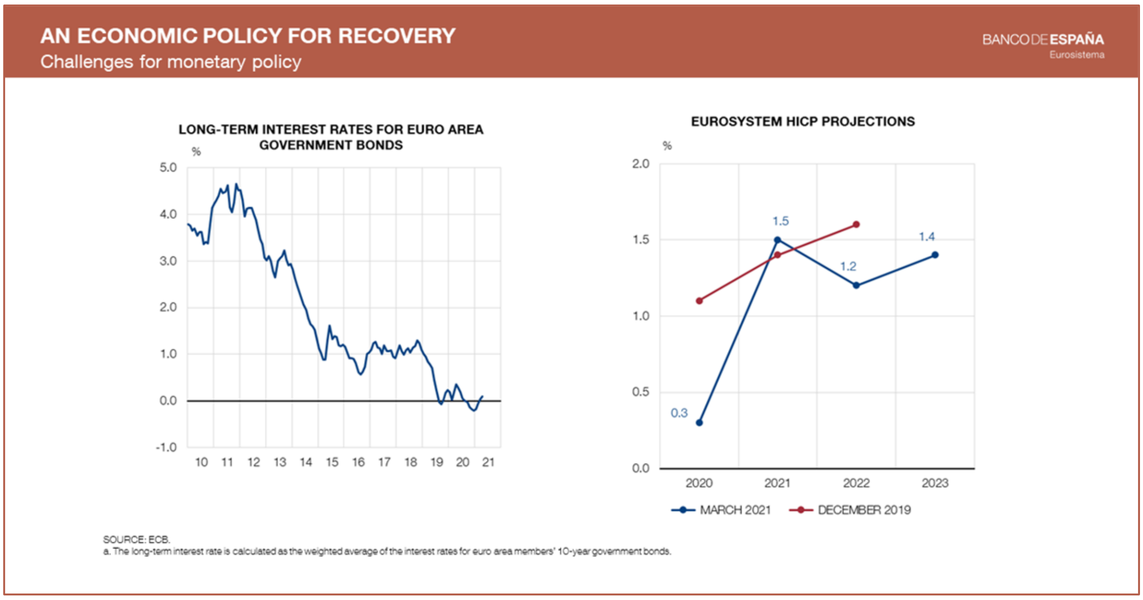
3.1. Global policies

Globally, concerted action in the short term remains essential. In a setting in which the recovery is proving uneven across countries, this will require some coordination in crisis exit strategies and, in parallel, support for the most vulnerable countries. International cooperation is particularly important for speeding up vaccine production and providing for its fair and affordable distribution for all.

Many of the challenges our economies face are global and require a global response. Accordingly, it would be very timely to give fresh impetus to multilateralism with three goals in mind: acting jointly to entrench the economic recovery; countering the backsliding in inequality and poverty caused by the pandemic; and tackling the challenges associated with digitalisation, international taxation and combating climate change, among others.

And this without forgetting the need to reinforce the common pre-emptive and response instruments in the face of systemic crises. In this respect, the G-20 agreements reached to respond to the impact of the crisis in low-income economies are praiseworthy. But we now need to forge a consensus to tackle the situation of the middle-income countries, some of which are facing this crisis with limited room for manoeuvre in their national policies.

3.2. Monetary policy



In the case of monetary policy, we must avoid a premature tightening of financing conditions. In this connection, at the ECB we have stressed that PEPP purchases will be adjusted to counter a deterioration in financing conditions that is not accompanied by a return by the medium-term inflation projection to its pre-pandemic level.

The increase in the volume of monthly purchases agreed in March this year was precisely for this reason. The rise in long-term interest rates and the increases in inflation observed in 2021 were estimated to be essentially transitory, meaning that the ECB's medium-term inflation forecasts (1.4% in 2023) held far below our objective and also below the pre-pandemic inflation path.

This is the framework for action – combining the ongoing joint assessment of financing conditions and of the expected inflation path – which we will pursue in the coming months when determining the pace of PEPP purchases, including their possible extension.

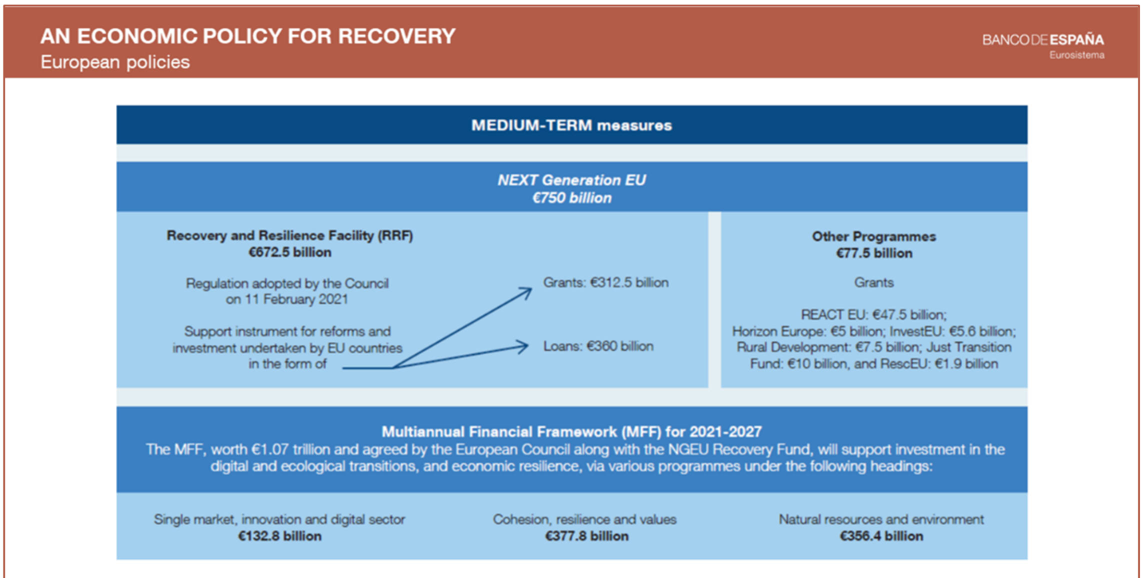
Monetary policy must also address significant structural challenges, arising from a setting in which inflation is persistently below our objective, with very low estimates of the "real natural interest rate" and the widespread application of non-standard measures. This is why we have launched a review of our strategy at the ECB, which will finalise in the second half of this year.

The recent experience of the US Federal reserve is, in my opinion, significant. Its strategy review illustrates the advantages of allowing its inflation objective to be moderately and temporarily exceeded in a setting in which inflation is persistently below target and nominal interest rates are close to their lower bound. This is the environment that has characterised the euro area in recent years.

However, a pre-requisite for hypothetically adopting an effective strategy allowing inflation to rise gradually and temporarily above target is, precisely, that there should be a clear numerical inflation objective. The current ECB objective – an inflation rate below, but close to, 2% – does not indicate a specific numerical objective. A rate of 2%, understood symmetrically, would be a good option.

The US experience also helps illustrate the role of fiscal policy in the current context, and also in relation to the challenges facing monetary policy. In a dual sense, a fiscal stimulus would exert upward pressure on prices and, if the stimulus were appropriately designed, it could raise the potential growth rate and, therefore, the real natural interest rate. That would narrow the gap between effective and natural interest rates, providing additional support to aggregate demand and to inflation.

3.3. European policies



SOURCE: Banco de España, drawing on European Commission data.

The NGEU programme has entailed substantial headway in European policies. Its short-term impact and its long-term transformational capacity would be maximised if, along with the swift preparedness of the Member States, it were accompanied by governance arrangements effectively linking the use of the funds either to those spending items with most capacity to increase growth potential or to structural reforms geared to this same goal.

That said, the NGEU cannot be considered as the cyclical stabilisation mechanism the euro area needs to complement the single monetary policy. We need to design a genuine stabilisation mechanism that is permanent in nature, with sufficient funding, and tax and debt capacity.

This ties in with the debate on the reform of fiscal rules to adapt them to the transformations that have come about since they were formulated. On one hand, the secular decline in long-term interest rates means that higher debt levels can be maintained without compromising public finances in the long run, provided that potential growth has not fallen in parallel. On the other, the international financial crisis and the pandemic have shown that tail risks are not always manageable exclusively on the domestic front. Indeed, it is possible that most of the biggest euro area countries are lacking the fiscal buffer needed to face a recession in the coming decade, even if they follow the Stability and Growth Pact rules.

Thus, a new framework is needed in which the national and supranational fiscal authorities complement one another. The national authorities should focus on fulfilling the medium-term budgetary objective, with public debt sustainability as their main point of reference, and on tackling asymmetric shocks. The supranational authorities should respond to tail events and adapt the fiscal policy stance at the euro area level to complement monetary policy.

There is also a need to simplify the current framework, improving its hitherto scant capacity to ensure that countries build up fiscal buffers in good times for use in future crises.

Nor can we forget that we still do not have a complete banking union, which will call for a common and fully mutualised deposit guarantee scheme, and that capital markets in Europe remain relatively under-developed and under-integrated. Hence the need to move resolutely towards approving the measures included in the capital markets union project.

3.4. Domestic policies

Short-term stimulus measures should continue to focus on the sectors, firms and groups of workers most affected, retaining the necessary flexibility to contend with the challenges created by this new phase of the crisis. In particular, it would seem advisable to extend furlough schemes, in force until end-May 2021, with a design that responds to the dual goal of maintaining a relatively generalised level of protection and, in turn, fomenting future reallocation across sectors and firms.

In this phase of the crisis, economic policies should also focus on minimising the damage to the productive system. The aim should be to prevent the closure of those ailing firms which nevertheless continue to be viable.

AN ECONOMIC POLICY FOR RECOVERY

Domestic policies' role in minimising the damage caused by the crisis

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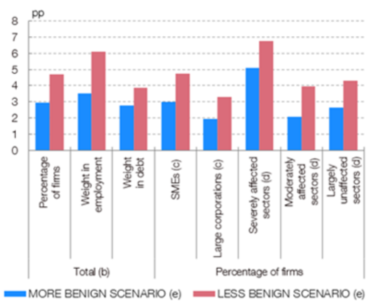
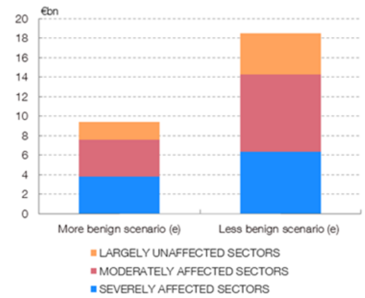
INCREASE, OWING TO THE COVID-19 CRISIS, IN THE PERCENTAGE OF VIABLE BUT OVERINDEBTED FIRMS AND IN THEIR WEIGHT IN EMPLOYMENT AND DEBT (a) (f)



UNSUSTAINABLE DEBT OF FIRMS THAT WOULD BECOME OVERINDEBTED BUT REMAIN VIABLE. SECTORAL BREAKDOWN (d) (f)



SOURCE: Banco de España.

a Changes, with respect to a counterfactual scenario, in the median of 100 micro-simulations in which each firm is randomly allocated a variation in 2020 sales such that the distribution of sales observed for each sector and firm size is replicated. The counterfactual scenario is consistent with the Banco de España December 2019 macroeconomic projections. Firms at risk of non-viability are defined as those with negative ordinary earnings (the sum of gross operating profit and financial revenue) in 2023.

b Excluding holding companies and firms in the following sectors: financial services, property development and buying and selling of own real estate.

c The definition of size is in line with European Commission Recommendation 2003/361/EC.

d Sectors are defined as severely affected if their sales fell by more than 15% in 2020 and as moderately affected if their sales fell by between 8% and 15%. Other sectors are deemed to be largely unaffected.

e Scenarios consistent with the baseline scenario (more benign) and severe scenario (less benign) of the Banco de España March 2021 macroeconomic projections.

f Overindebted firms are defined as those with positive net debt in 2022 and whose debt ratio (calculated as Total net debt for 2022 / Ordinary earnings for 2023) exceeds 12 in the more benign scenario and 9 in the less benign scenario. Net debt is defined as borrowings (interest-bearing or non-interest-bearing) less cash and cash equivalents, short-term financial investments, inventories and debts pending collection.

In this respect, an aid package for the business sector and the self-employed has recently been approved. The analysis set out in the *Annual Report 2020* shows that the requirements for applying for the aid are based on criteria involving belonging to specific sectors and a fall in turnover. In light of that, there is a risk that such aid will not reach all firms which, while viable, are strapped by excess debt. This risk derives from two facts: i) that even in the sectors not among those most affected by the crisis there would have been an increase – albeit one less generalised – in insolvency problems; and ii) that insolvency status also depends on the pre-crisis starting position in relation to profitability and debt levels. Making the aid programme more flexible in its application by regional governments, as approved in April, could mitigate this risk.

In short, for this tool to be useful its implementation must be swift and uniform, and the distribution mechanisms should allow aid to be focused on viable firms with solvency problems. Also needed is flexibility in the volume of the funds so as to adapt them to the course of the pandemic and the potential materialisation of risks.

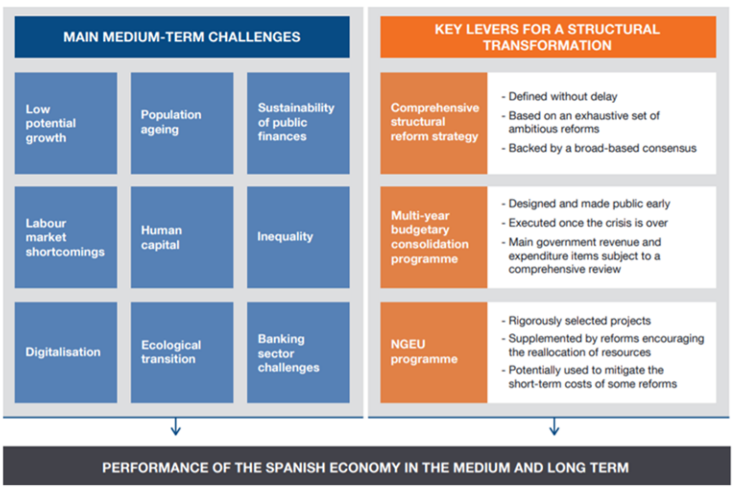
The analysis in this Report also detects pandemic-related risks to citizens' health and education, which should be appropriately tackled. Specifically, an increase in the incidence of mental health problems has been observed, especially among women, and there have been delays in access to healthcare, with possible consequences for long-term health. The closure of education centres in the last academic quarter of 2020 and the subsequent shift to education using digital media might have adversely affected academic results, especially among the underprivileged, although various measures have been adopted to mitigate this outcome.

In parallel, it is vital to pave the way for the economy to adapt to the new circumstances arising in the wake of the pandemic, e.g. greater digitalisation, the use of e-commerce and working from home. This necessarily involves allowing the use of the flexibility mechanisms provided for under legislation – in particular labour law – so that the necessary reallocation of resources across sectors and firms may come about.

The functioning of corporate debt restructuring and insolvency mechanisms also needs to improve, especially for those business projects deemed non-viable in the medium term.

And, in turn, training policies for employees and the unemployed must be strengthened to provide for retraining and reassignment to the jobs of the future, thus preventing an increase in structural unemployment. Such reinforcement is particularly important in a setting of continuous and intensive technological change and given the gradual ageing of the workforce.

AN ECONOMIC POLICY FOR RECOVERY
Domestic policies' role in tackling the economy's medium-term challenges

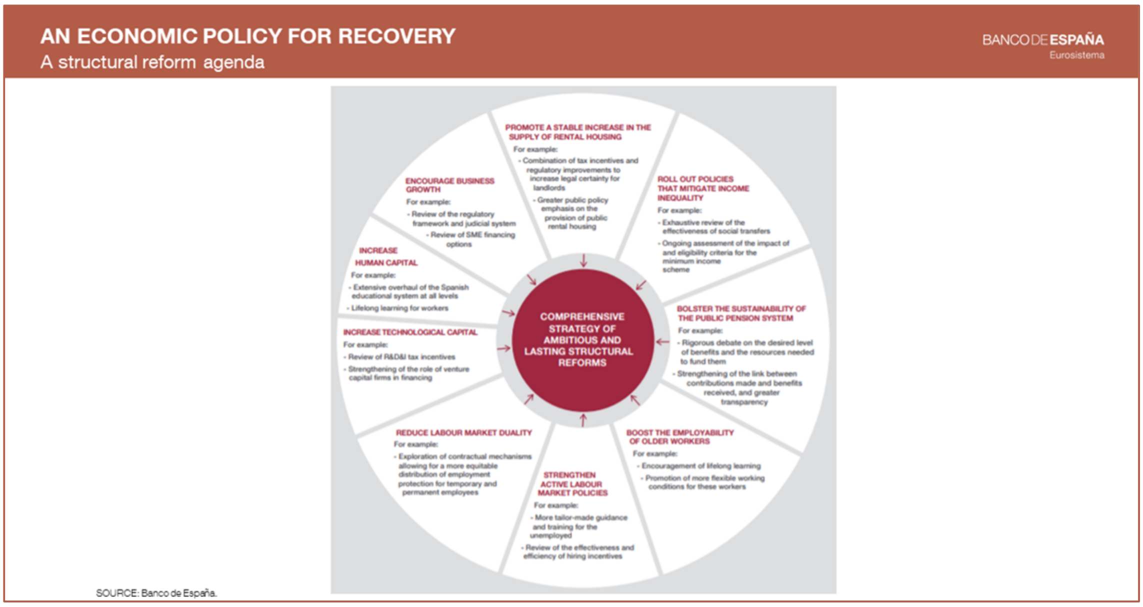


SOURCE: Banco de España.

In any event, the medium-term outlook is conditional upon a series of structural challenges that were already in place before the crisis, some of which may have been accentuated in the wake of the pandemic. These challenges include most notably: i) low productivity growth; ii) labour market dysfunctions; and iii) the challenges stemming from population ageing, climate change and increased inequality. And, in parallel, the downturn in public finances to be redressed.

Tackling these structural challenges calls for the design of a comprehensive strategy. In this connection, three essential levers should be considered: the design and approval of an ambitious structural reform agenda; the implementation of those public investment projects with most long-term traction under the NGEU programme; and the definition and application of a budgetary plan that enables fiscal policy leeway to be recovered once the crisis is behind us.

Regarding the structural reform agenda, I shall not go into detail on each priority, given that I previously set them out before this house last June.[1] However, I should like to briefly mention some essential avenues for action.



To raise productivity, it would be advisable, first, to conduct a review of the regulatory framework in order to promote business dynamics and growth, increase the degree of sectoral competition and reduce the current obstacles to the singleness of the market. And further, to develop policies that stimulate human capital accumulation, an area where Spain has serious shortcomings compared with other developed economies. Hence the advisability of rethinking the institutional design of the education system, curriculum content and the very system of learning, and of reinforcing lifelong training mechanisms for workers.

Technological capital is another key pillar with which to underpin productivity gains. Apart from the budgetary resources that may stem from the NGEU funds, changes would be desirable to the researcher promotion and career system so as to stimulate the entry and development of promising new researchers. It would also be worth redesigning incentives

[1] See P. Hernández de Cos (2020), "The main post-pandemic challenges for the Spanish economy. Appearance before the Parliamentary Committee for the Economic and Social Reconstruction of Spain after COVID-19. Congress of Deputies – 23 June 2020", Occasional Papers, no. 2024, Banco de España.

to foment business investment in this area, and to boost the role of venture capital firms in its financing.

In the labour market, reducing the high duality between permanent and temporary employees would help reduce some of the market's main structural flaws, which see temporary workers disproportionately bearing the brunt of adjustments costs and which cause structural unemployment to be higher than in the other euro area countries.

Productivity gains and a better-functioning labour market would help reduce the high levels of inequality prevailing. However, the recent course of inequality in Spain has different dimensions that also require different instruments to tackle them. The crisis is expected to have increased inequality levels, including that associated with the uncertainty over future incomes, which particularly affects the young.

Action in this area should start with an efficiency analysis of the various redistributive arrangements in place. This is the case of the minimum living income programme, provided for by the law, where it would be desirable to analyse its effects on labour market participation or its degree of coverage. This is because, in its initial design, some groups which might nevertheless be at risk of extreme poverty are not eligible. In addition, measures aimed at increasing the supply of rental housing would be appropriate.

One of the dimensions of inequality that has progressively come to the fore in the public debate concerns the disparities in the demographic dynamics of Spain's regions. The *Annual Report 2020* devotes a chapter to studying this phenomenon. It concludes that the concentration of population in Spain is very high from the European perspective, both in urban and rural areas, and that Spain has an exceptionally high percentage of uninhabited territory. Further, the study identifies a risk of depopulation for 42% of municipalities.

Migration from the smallest towns to the major cities has contributed to the diminished dynamism of the rural municipalities around the smaller towns; the wage premium is the main determinant of this migration, especially for skilled workers. Indeed, the largest cities lost unskilled workers between 2005 and 2018.

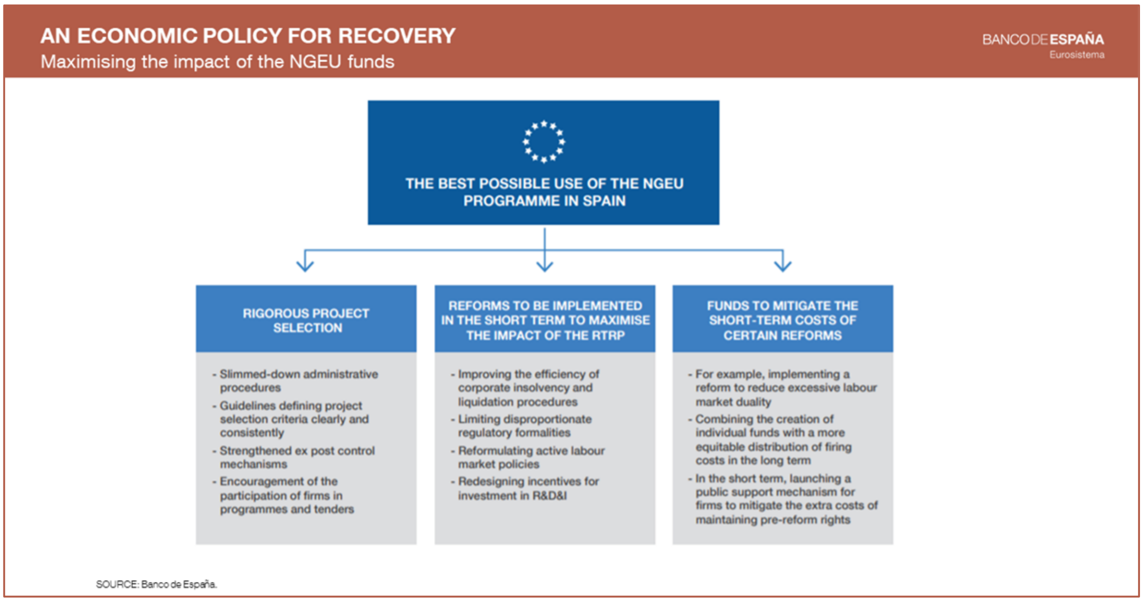
Digitalisation, population ageing and the energy transition pose new challenges, but also opportunities for the development of the rural world. Against this background, it is important to consider depopulation-mitigation policies that seek to check the demographic decline and promote the development of rural areas in the medium term. Depopulation-adaptation policies are also needed, aimed at maintaining a minimum level of services that ensure the well-being of rural dwellers.

We can conclude from the review of certain international experiences that a comprehensive strategy that takes the long view is necessary. There must also be a clear definition of competencies, financial autonomy, collaboration mechanisms between municipalities and specific objectives that are measurable ex-ante, with an ex-post assessment of effectiveness.

Moreover, the reform agenda should address the challenge of population ageing. This calls for action in different areas, such as improving the work-life balance (in particular for young women with children), adjusting migratory policy to the needs of the labour market and measures conducive to prolonging working lives.

And, of course, we must face the consequences for the financial sustainability of the public pension system. Demographic dynamics will entail a notable increase in pension spending in the coming years, and the return to an inflation-based revaluation system and the suspension of the application of the sustainability factor will add further pressure. The reform of the system should strengthen the link between contributions made and benefits received (ensuring a level of sufficiency for the most vulnerable households), increase the transparency and predictability of the system, and incorporate inter-generational equity considerations. It would also be advisable to introduce automatic mechanisms that adapt certain parameters of the system to demographic and economic dynamics so as to ensure sustainability, offer certainty to citizens and promote prudent decision-making in respect of saving, work and retirement.

Finally, moving towards a more sustainable growth model will require a deep-seated economic and technological transformation to mitigate the effects of climate change. Here, public policies should play a key role, in particular through environmental tax, seeking the highest possible degree of international coordination.



The second lever for the structural transformation of the economy is the NGEU programme, in light of the amounts of funds involved and its structural focus, especially in the digital and environmental areas.

However, maximising its effect on long-term growth poses significant challenges.

First, the ex-ante selection of projects should be based on appropriate public procurement procedures. Moreover, there should be appropriately designed methodologies to monitor the initiatives in real time, allowing for the correction of possible deviations, and a sound assessment framework a posteriori.

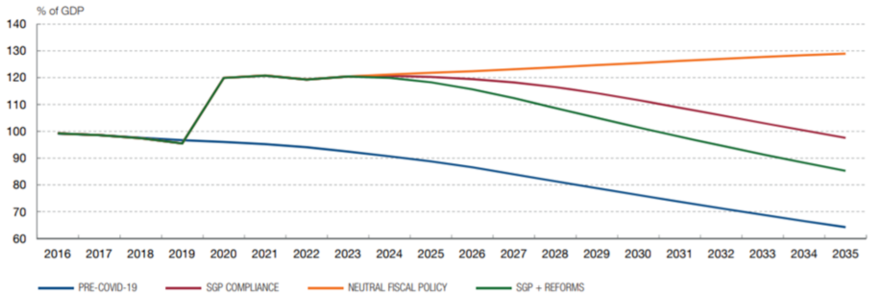
We must likewise ensure there are no obstacles that hamper the reallocation of resources across firms and sectors that the future structural change to our economy will require. Structural transformation necessarily calls for economic flexibility.

Finally, to spur the implementation of structural reforms, a portion of the resources might be used to mitigate the costs that these reforms might, on occasion, entail for certain groups in the short term, in pursuit of the benefits they would generate for society as a whole in the medium and long term. By way of illustration, the *Annual Report 2020* describes a calibrated mechanism for the Spanish economy to combat the duality of our labour market. It is based on the accumulation of entitlements in workers' individual funds and on the reform of dismissal costs, whose implementation could be assisted by the use of European funds to cover the transition costs. The example is calibrated in such a way that firms, on the whole, continue to bear the same aggregate amount of severance payments that they do under the current arrangements. What is sought under the new scheme is a fairer distribution of severance payments among workers than is currently the case. This reform is just one example among many possibilities to tackle the problem of duality. It would be desirable to assess the different alternatives, in particular at a time at which a portion of the European funds could be used to boost this type of reform.

SUSTAINABILITY OF PUBLIC FINANCES
Rebuilding fiscal space

BANCO DE ESPAÑA
Eurosistema

SIMULATED PATHS OF PUBLIC DEBT UNDER THE BASELINE SCENARIO AND UNDER CERTAIN ASSUMPTIONS



SOURCE: Banco de España. Cut-off date: 30 April 2021

The third lever is the definition and implementation of a budgetary plan that allows fiscal leeway to be reconstructed and that reduces the vulnerability derived from high public debt in the face of changes in financing conditions and in investor sentiment.

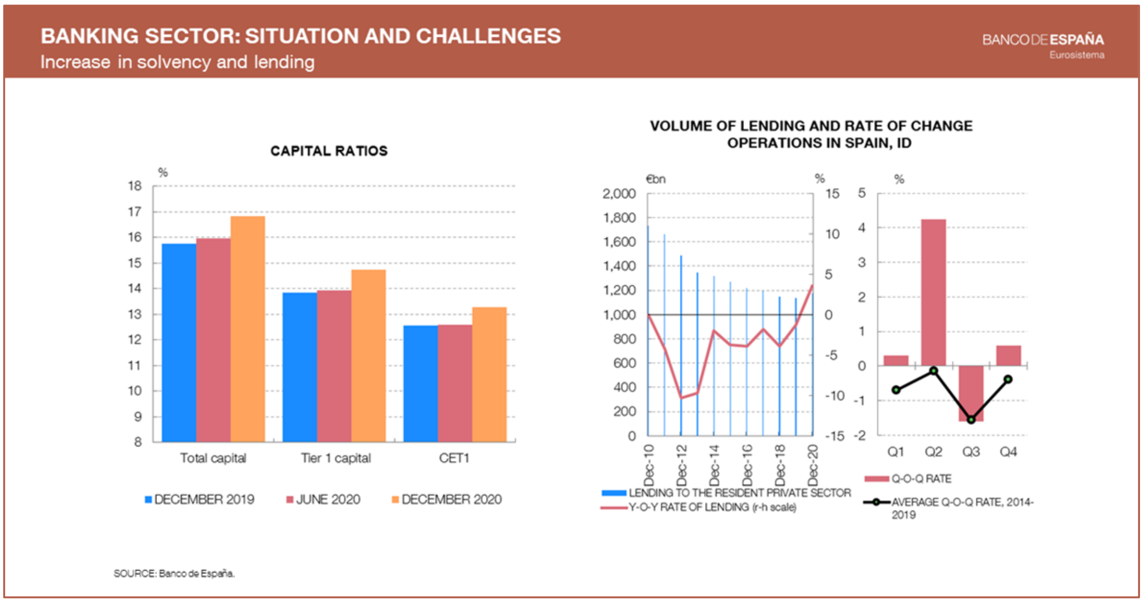
It should be borne in mind that the public debt/GDP ratio has increased by almost 30 pp from 95.5% in December 2019 to 125.3% in March 2021. And the structural budget deficit, which already exceeded 3% of GDP in 2019, might reach a figure of close to 5% after the crisis.

Given this starting position, the effort required is clearly considerable and will need to run for several years. To strengthen the credibility of this plan, the early definition and communication of its main characteristics would be desirable, as would the active participation of all tiers of government. The plan, in combination with the aforementioned structural reforms, would alleviate adjustment needs insofar as such reforms are capable of increasing the economy's potential growth.

The decision on how to distribute the adjustment among the different budgetary items must be adopted in the political sphere. However, it should be based on a review of all budgetary headings that assesses the degree of efficiency with which public spending and revenues are implemented and raised. The consequences of any fiscal intervention must also be analysed, in terms both of economic growth and of redistribution.

4. Situation and challenges of the banking sector

In the wake of the financial crisis, the application of the global regulatory reform and the process of restructuring prompted banks to increase their solvency and resilience, which has enabled them better to weather this crisis. Indeed, banks have been a key factor in the transmission of monetary policy decisions and in the implementation of certain financial and fiscal measures.



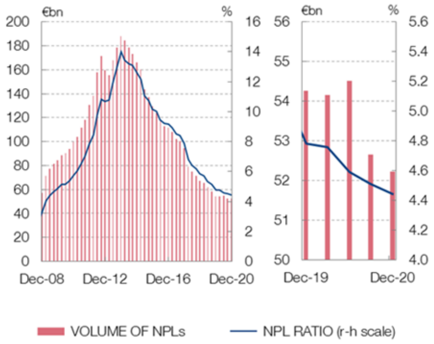
In parallel, these measures have helped mitigate the effects of the crisis on the sector. Its solvency ratio (CET1) rose, despite the severe economic downturn, by 71 basis points (bp) to 13.3% at end-2020.

At the same time, bank lending to the private sector in Spain increased in 2020 by 3.5%, breaking the previous trend. The role of the measures applied has, once again, been very important. Thus, credit drawn down in operations linked to the ICO's guarantee facilities accounted for 18% of total new credit and 34% of credit to non-financial corporations and sole proprietors. Moreover, the evidence available shows that banks have used Eurosystem financing to lend to the real economy and that banks which did not distribute dividends were more active in granting loans.

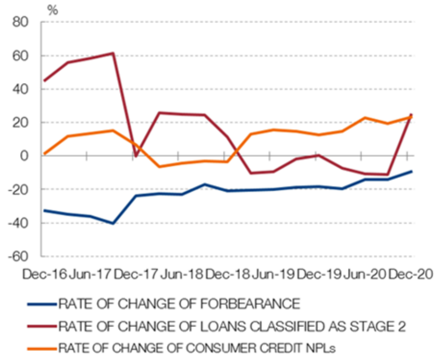
BANKING SECTOR: SITUATION AND CHALLENGES
Credit risk

BANCO DE ESPAÑA
Eurosistema

NPLs AND NPL RATIO OF THE RESIDENT PRIVATE SECTOR
Operations in Spain, ID



SIGNS OF EARLY DETERIORATION IN LENDING TO THE RESIDENT PRIVATE SECTOR
Operations in Spain, ID



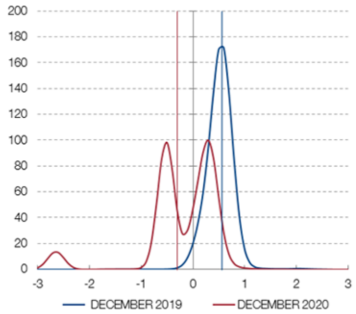
SOURCE: Banco de España.

In turn, non-performing loans (NPLs) continued to decline, albeit at a lesser pace than in the preceding years. However, in 2020 Q4 there were signs of worsening credit quality, such as the increase in NPLs in certain segments (consumer credit, for instance), the slowdown in the fall in refinanced credit and a strong increase in loans subject to special monitoring.

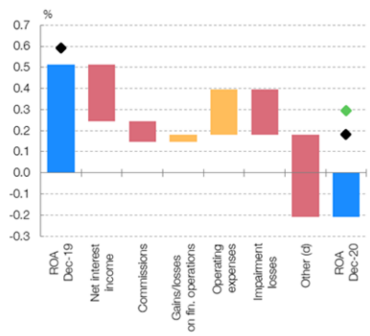
BANKING SECTOR: SITUATION AND CHALLENGES
Impact on profitability

BANCO DE ESPAÑA
Eurosistema

DISTRIBUTION OF ROA (a) (b)



BREAKDOWN OF CHANGE IN ROA
Net consolidated profit as a % of ATA (c)



SOURCE: Banco de España.
a The chart depicts the ROA density function for Spanish deposit institutions, weighted by the amount of average total assets. The density function is proxied using a kernel estimator, which enables non-parametric estimation and provides a continuous, smoothed graphic representation of the function. The blue and red vertical lines denote the ROA of the Spanish banking system as a whole in 2019 and 2020, respectively.
b The negative mode closest to zero relates to large significant institutions whose earnings in 2020 are largely explained by negative extraordinary adjustments. The most extreme negative mode relates to another significant institution with accounting adjustments linked to a merger process.
c The red (yellow) colour of the bars indicates a negative (positive) contribution of the item concerned to the change in consolidated profit in December 2020 with respect to December 2019. The black diamonds show the ROA excluding both the adjustments to goodwill recorded in 2019 (-€2.8 billion) and 2020 (-€12.2 billion) and the deferred tax asset adjustment recorded in 2020 (-€2.5 billion). The pink diamond shows the ROA in 2020 excluding, in addition to the aforementioned adjustments, the deterioration in value arising from accounting reclassification (-€5.6 billion) and the extraordinary positive results recorded in 2020 (€1.2 billion).
d Including adjustments to goodwill and other extraordinary adjustments.

The banking system’s net consolidated income was negative in 2020, which translated into a return on assets (ROA) of -0.21 %, 72 bp down on 2019. A significant portion of this decline is accounted for by the extraordinary adverse factors at three of the main banks. If the main extraordinary factors were excluded, ROA would have stood at 0.3%. In any event, the downward pressure on profitability was generalised across banks and was due, in particular, to the increase of over 50% in impairment provisions.

The prospect of economic recovery translates into improved expectations for the sector. In fact, in 2021 Q1, the return on equity (excluding extraordinary impacts) for listed Spanish banks stood at 8%, still below the estimates regarding the cost of capital (8.9%).

But risks to financial stability persist and there has been an increase in vulnerabilities, stemming from the narrowing of margins and the reduction in banks' capital-generating capacity, along with the weakening financial position of households and firms.

To manage these risks, the supervisory authorities have continued to stress that the use of capital buffers is appropriate for recognising credit impairment and for continuing to provide solvent credit. Banks will have time enough to meet capital requirements once more and the process will not begin until the main effects of the pandemic have dissipated.

In parallel, we have recommended to banks that they act with extreme prudence in their dividend distribution and variable remuneration policies for three reasons: the uncertainty still in place; the fact that the impact of the pandemic has not been fully felt on bank balance sheets; and because they continue to benefit from various public support measures.

At the same time, banks should continue with the policy of anticipating the recognition of credit losses, thus ensuring appropriate and timely recognition in keeping with supervisory guidance. In this respect, in 2021 Q1 the non-performing loans ratio in the hospitality and leisure sectors increased by 1.1 pp and the volume of loans subject to special monitoring continued to increase at a pace of 8.1% quarter-on-quarter. Also, as was to be expected, the signs of impairment in guaranteed loans portfolios and in those subject to a moratorium are greater than the rest. Overall, it is likely that the provisioning drive will have to continue over the coming years.

Concurrently, we must ensure that the banking sector remains resilient to any new risks that may emerge.

In particular, the implementation of the latest Basel III global reforms remains pending. The aim, which remains fully pertinent, is to homogenise the calculation of risk-weighted assets. To achieve this, a key element is the so-called "output floor", which sets a floor to the deductions banks may obtain through the use of in-house models to calculate minimum capital requirements as opposed to the standard approach.

Moreover, the Banco de España is in the process of amending Circular 2/2016, to render operational the new macroprudential instruments conferred upon it by national legislation. These instruments, which include lending standards requirements, will improve our capacity to act ahead of potential episodes of excessive or inappropriate credit growth.

We would also be well-advised to reflect on our institutional financial architecture. Some countries have moved towards more integrated arrangements involving a bigger role for central banks. Among these arrangements is the separation of the respective responsibilities for preserving the financial soundness of all financial institutions irrespective of their nature (banking, insurance, securities, etc.) and for overseeing conduct in relations with clients, and their assignment to separate authorities (to the Banco de España and to the National Securities Market Commission (CNMV), respectively). This is, in my view, an optimal institutional arrangement for managing potential conflict between these two responsibilities and for improving the efficiency and effectiveness of supervisory activity.

In this reflection we should also include bank resolution functions, which in Spain are separated between those relating to prevention and those to execution (in the hands, respectively, of the Banco de España and the FROB), within the framework of the European Single Resolution Mechanism. This is a more complex arrangement than that in other countries, where the two functions are generally unified under the agency responsible for banking supervision (the Banco de España, in Spain's case), which is justified by reasons of the informational economy, costs and consistency in the assessment of the implications for financial stability.

Among the new risks emerging, there is a notable need for the financial sector to include those associated with climate change. We financial supervisors must ensure that banks correctly price these risks and incorporate them into their management, and we must pave the way for the development of appropriate reporting standards and databases for their measurement.

As to the risks arising from technological developments, I would stress, in addition to those associated with cyber-attacks, the possibility that growing competition from BigTech may become potentially disruptive. The various authorities will need to adopt a proactive stance to question the regulatory perimeter so as to ensure the maxim "same activity, same risks, same rules" applies.

Technological competition might also exert additional pressure on the sector's profitability. Accordingly, it is essential that banks should further explore the scope for efficiency gains, cutting costs and using new technologies more intensively.

In our capacity as central banks and financial supervisors, we must adapt to the new technologies. In the Eurosystem we are in the process of setting the objectives and terms for a future digital euro, conceived as a tool to stimulate innovation and act as a catalyst for competitiveness and growth. It would also provide support in safeguarding our monetary sovereignty and could, moreover, increase the external role of our currency and, by extension, our capacity to exert influence beyond our borders. This is an ambitious approach which will necessitate addressing this design with an open mind, while taking the necessary precautions to ensure that all relevant dimensions (such as financial stability, monetary policy and the configuration and role of the finance industry) are duly taken into account.

5. Conclusion

Allow me to conclude by reiterating one of the main messages I have wished to convey to Spanish society since the start of this unprecedented crisis. The challenges the Spanish economy faces are structural, and structural challenges require structural responses. The design and implementation of this response should be based on broad consensus, so that it may endure and prove credible. Such consensus must be fully compatible with the ambition and urgency required by the scale of the challenges to our economy. Our future prosperity will largely depend on the timeliness, ambition and long-sightedness of the decisions we take to address these challenges.

Thank you.