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Financial stability challenges and policies in the face of the pandemic

Closing address. XI Financial Sector Meeting/Expansión - KPMG

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Governor

Good afternoon, ladies and gentlemen.

Let me begin by thanking the organisers for inviting me to participate, once again, in this annual meeting on the financial sector. It is a pleasure to deliver the closing address at an event in which experts on the Spanish and global financial system have discussed some of the challenges facing the sector. The serious and rigorous debate this meeting has elicited is particularly significant in a situation such as that we are facing, in which the economic crisis caused by the pandemic is now also giving rise to undeniable consequences for the financial system.

EFFECTS OF THE CRISIS ON ACTIVITY: AN UNPRECEDENTED AND PERSISTENT IMPACT; A PARTIAL, UNEVEN AND UNCERTAIN RECOVERY

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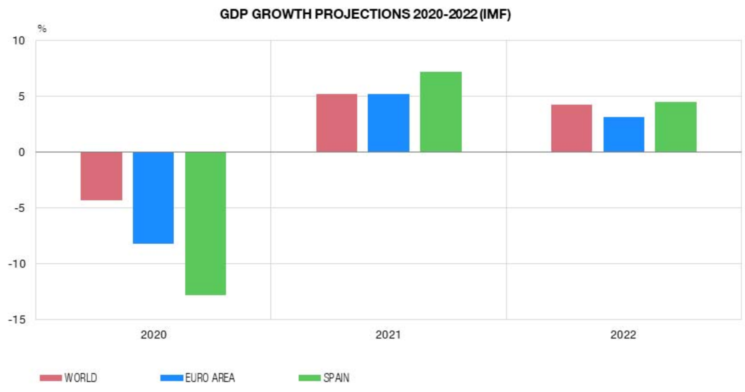

SOURCE: IMF (WEO, October 2020).

At this stage of 2020, it is clear to all that the health crisis and the measures needed to contain it have had a deep-seated macroeconomic impact worldwide. Clearly, too, the persistence of this shock, which should in principle be considered as temporary, is also proving most substantial; the fresh outbreaks of the disease are forcing us to maintain – and even further tighten – the restrictions on activity and on people's movements and interaction. This persistence makes it more likely there will be unwanted structural damage beyond the structural changes which, we are beginning to see, will come about as a result of this crisis. Also evident is the enormous degree of heterogeneity in the effects of the crisis, both across regions and across sectors and firms, and population segments, with the Spanish economy being one of the most affected so far.

But perhaps the most significant characteristic, from the economic standpoint, is the enormous uncertainty over how the pandemic will evolve and, of course, over its economic effects, conjunctural and structural alike. Such uncertainty will continue to hamper consumption and investment-related decision-making and will, therefore, continue adversely affecting economic activity and employment.

The main message I wish to convey is that, faced with such a complex and uncertain environment, the main contribution of economic policy should be to provide certainty to economic agents. And that applies both to European and domestic economic policy, in its monetary, financial and fiscal facets. We must support the recovery, but also smooth the structural adaptation of the economy and, above all, resolutely face up forthwith to the long-term challenges. This long-term orientation should provide guidance and stability to economic agents. And that, in turn, would increase the effectiveness of the stimulus measures still needed in the short term. The credibility of this long view calls for the different agents (political, economic and social) to forge a broad consensus, underpinned by a stable and sound institutional framework and governance.

In addition, in the financial realm, in the context of the current crisis, the shared objective should focus on preventing the health and economic crisis from turning into a financial one. We are all aware of the severity and persistence of crises which, in the past, had a significant financial component.

Against this background, I would like to focus today on analysing the main risks this crisis is generating for financial stability, and on the economic policy measures which, in my view, have been and will be necessary to mitigate them.

1 The risks to financial stability

The unprecedented impact of the pandemic on economic activity has entailed a very significant increase in the risks to global financial stability. The forceful economic policy response and the effect of the far-reaching international financial reform implemented in the past decade are helping mitigate and manage these risks. Indeed, to date, the financial system is acting as a mitigating as opposed to an amplifying factor of the impact of this crisis. But we should not be complacent. As I have stressed, the scale of this shock is very high, and its duration uncertain.

I shall go on to review the recent developments in the main risks in this area, drawing on the analysis of the effects of the crisis on the economy's different agents: non-financial corporations, households, the financial sector and general government.

NON-FINANCIAL CORPORATIONS: GROWTH IN INDEBTENEDNESS AND A WEAKER OUTLOOK FOR DEMAND LEAVE THEM MORE VULNERABLE, ESPECIALLY IN THE MOST AFFECTED SECTORS

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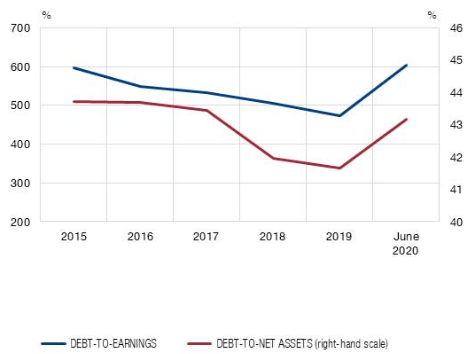
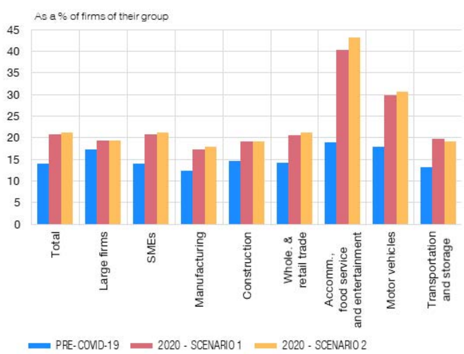
FIRMS' INDEBTEDNESS RATIOS. CBQ (a) (b)



SOURCE: Banco de España.
a. CBQ is the quarterly survey of the Central Balance Sheet Data Office.
b. Earnings: gross operating profit + financial revenue. Net assets: assets net of non-interest-bearing borrowing.

VULNERABLE FIRMS ACCORDING TO THE DEBT-TO-NET-ASSETS RATIO (a)



SOURCE: Banco de España.
a. CBQ is the quarterly survey of the Central Balance Sheet Data Office.
b. Earnings: gross operating profit + financial revenue. Net assets: assets net of non-interest-bearing borrowing.

First, **non-financial corporations**, which faced this shock from a more favourable financial position than that before the global financial crisis. Specifically, they had substantially reduced their debt levels, which at end-2019 were below the European average, and had higher liquidity buffers. Moreover, the sectoral distribution of activity was more balanced than was the case prior to the previous crisis.

However, the information for the first half of the year shows that these firms' profitability has fallen abruptly. Their ROA halved, from 4% to 2%, and the proportion of firms with low profitability increased. The percentage of firms with losses also rose by 11 pp, to 37%.

The simulations performed by the Banco de España point to a strong contraction in firms' profitability in 2020 as a whole, with more than half of the firms expecting losses over the full year and a more unfavourable performance by SMEs, and especially in companies in the hospitality industries, and in the motor vehicles, retail trade, and transport and storage sectors.

The simulations by the Banco de España on firms' liquidity also anticipate that the percentage of firms with liquidity needs are expected to increase from Q2 to Q4 this year by almost 10 pp to 70% as a result of the pandemic.

The information on bank lending shows that firms are resorting to this source of financing to cover a significant portion of their liquidity needs. Indeed, the outstanding balance of credit to non-financial corporations extended by domestic credit institutions turned from a year-on-year contraction of 1.1% in February into a year-on-year expansion of 8.1% in June, although this increase eased in July and August.

One of the most significant factors in the increase in credit over these months has been the progressive activation of the Official Credit Institute-managed line of public guarantees to non-financial corporations and to individual entrepreneurs. Of the total new credit extended between December 2019 and June 2020 to non-financial corporations, 41% related to operations with a guarantee, and this proportion exceeded 60% at SMEs and at firms whose activity was concentrated in the sectors most affected by the crisis. Also important is the fact that the lending standards for these guaranteed loans have been more favourable in terms both of the interest rate applied and the maturity period, which will also help reduce future refinancing risks.

In parallel, the sector's aggregate debt ratio in terms of GDP has risen for the first time since 2010, to 82% in Q2 (the highest level since 2017). This is a consequence both of the increase in debt and of the decline in GDP. Although the intensity of these rises will be corrected to some extent when the GDP figures for the coming quarters are incorporated, the simulations by the Banco de España also point to a worsening financial situation.

Indeed, the percentage of firms with a high debt-to-assets level, proxied by a ratio higher than 0.75, will increase, according to these simulations, by 7 pp. This percentage is, in any event, modest in relation to the scale of the shock, among other reasons as a result of the intense deleveraging prior to the crisis. This increase will, however, be far higher (by over 20 pp in some cases) at firms in the sectors most affected by the crisis.

In terms of the debt-to-revenue ratio, the increase will be higher owing to the decline in the denominator. Specifically, the weight of firms with a net level of debt tenfold that of revenue, or with positive net debt and negative revenue, will increase by over 15 pp. And that figure could rise to 40 pp in the sectors most affected by the crisis. Admittedly, this ratio tends to overestimate the financial downturn, given that, obviously, the level of revenue this year cannot be taken as representative of future revenue. Moreover, low interest rates and the greater duration of loans granted during the crisis will also act as mitigating factors. However, this set of indicators serves to illustrate the solvency risks to non-financial corporations that we are facing.

HOUSEHOLDS: THE EFFECT ON EMPLOYMENT AND THE POTENTIAL PERSISTENCE THEREOF ARE THE MAIN SOURCE OF FINANCIAL VULNERABILITY FOR THIS SECTOR

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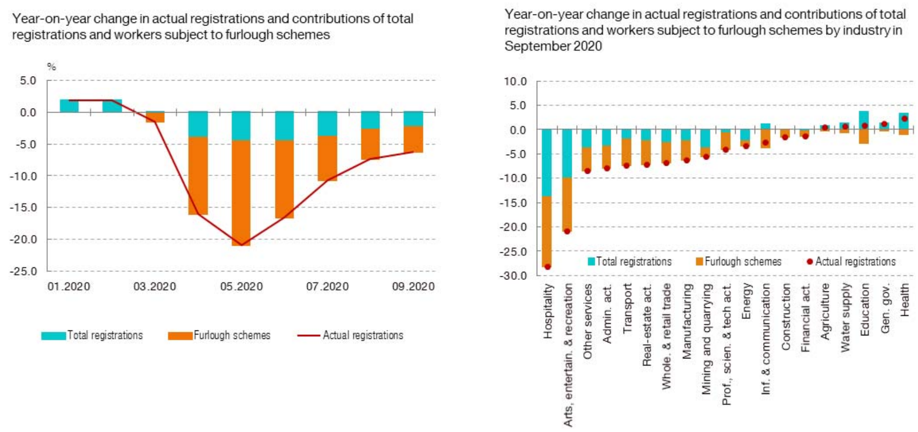

SOURCE: Ministerio de Inclusión, Seguridad Social y Migraciones.

Households also saw their financial situation improve significantly after the previous global financial crisis, while the conditions under which mortgage loans have been granted have been much more prudent. That said, consumer credit has been growing at high rates in recent years and there are still groups of households in a position of vulnerability.

Nonetheless, household income has also undergone a significant cut in the current crisis, owing to the reduction in hours worked and to the increase in unemployment. Specifically, households' gross disposable income (GDI) fell by 8.8% year-on-year in the first half of 2020.

In parallel, the credit obtained by households has fallen off in recent months as a consequence of the decline in new lending business. The reduction has been more marked in the consumer credit segment, whereas new financing for house purchases fell less sharply. Overall, although loan moratoria, which affect 7% of the outstanding balance of lending to households, have checked the decline in credit to this sector by reducing the volume of repayments, the year-on-year growth rate fell to -0.9% in August compared with the 0.3% increase in February.

These developments have meant an increase in the financial pressure borne by households. Thus, for the overall household sector, the debt-to-GDI ratio rose by almost 4 pp in the first half of the year to 95%. Once again, the intensity of this rise in debt will foreseeably ease to some extent with the GDI data for Q3. The increase in household saving not earmarked for debt service, the result of the heavy decline in consumption, appears to have been channelled towards bank deposits, which increased at a year-on-year rate of 7.1% in July.

However, there is no updated information available on the distribution of this saving within the household sector, making it difficult to assess to what extent this development is exerting a mitigating effect on the high degree of financial pressure for certain groups of households.

In this respect, from the standpoint of financial stability the heterogeneity marking households' financial situation is very significant. If we take the Banco de España's Survey of Household Finances, we find that the industries most stricken by the pandemic used proportionately more youths and women than other sectors, and employed a higher percentage of low-wage-earners. These lower wages would be partly offset by the fact that the employees affected would be living with other household members with higher incomes. As regards their wealth, 28% of the workers in the sectors that involve greater social interaction lived in 2017 in households whose financial assets accounted for less than one month's income, and around 8% had bank debts whose repayment exceeded 40% of the household's gross income. Therefore, the labour income and the financial situation of the households of these workers were, in 2017, more fragile than those of employees in the other sectors of activity.

BANKING SECTOR: ADVERSE IMPACT ON PROFITABILITY IN THE SHORT AND MEDIUM TERM. THE EFFECT ON SOLVENCY WILL DEPEND ON THE SCALE AND PERSISTENCE OF THE CRISIS

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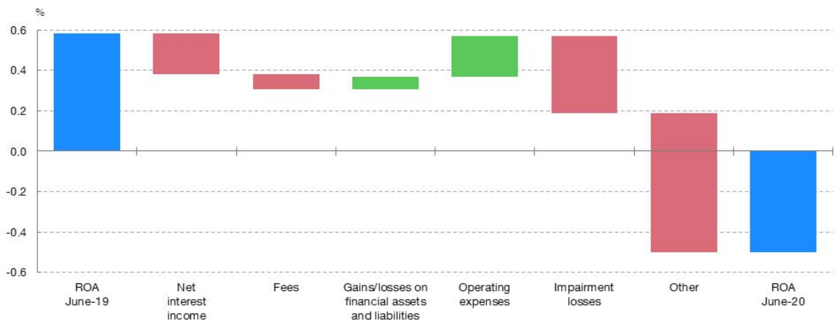
BREAKDOWN OF THE YEAR-ON-YEAR CHANGE IN PROFIT/LOSS IN H1



SOURCE: Banco de España.

Overall, therefore, the financial position of the non-financial private sector has worsened. The consequences of this deterioration for **credit institutions'** profits will become fully manifest in the coming quarters. Clearly, too, the improvements in the Spanish banking sector in terms of balance sheet quality and levels of solvency in the past decade have left it better placed to absorb this crisis and to continue providing the financing the economy needs. And the risks to financial stability stemming from the sector have been mitigated by the various economic policy measures adopted.

In any event, banks' income statements have already been adversely affected. In the first half of 2020, net consolidated income for the overall Spanish banking system was negative to the tune of around €9.5 billion. That marks a fall of almost €20 billion from the profits recorded in June 2019, making for an ROA of -0.5% (1.1 pp less than in June 2019) and a return on equity (ROE) of -7.3% (15 pp down on a year earlier).

This negative performance is due (in particular in the case of the two biggest institutions) to the deterioration in the goodwill of their subsidiaries abroad. That illustrates how, in the case of a global crisis like the present one, the international diversification of Spanish banks' business will foreseeably be less useful than in past crises for containing and mitigating the attendant effects.

In fact, the net result for the Spanish banking system as a whole would have been positive (0.14%) had this deterioration in goodwill and other extraordinary adjustments not been taken into account. In any event, the downturn in profitability was also due to greater provisioning in anticipation of future asset impairment, whereby impairment losses doubled compared with 2019. That explains why, for the remaining banks without an international presence, the reduction in profits averaged 60%.

Accordingly, the profitability of the sector has been far below what investors demand. As a result, the price-to-book ratio, which compares the stock market capitalisation of listed banks with their book value, contracted markedly in March in Spain, as in other European countries, falling to levels around 0.4. It did, however, pick up subsequently to some extent.

As I said, one aspect of recent developments that must be assessed is the fact that much of the adjustment to results is due to anticipated credit impairment provisions that have not yet materialised, but which will do so in the coming quarters, allowing these provisions to be appropriately distributed over time. Indeed, the downturn in economic activity prompted by the pandemic has only fed through moderately, so far, to non-performing loans. There has been a slight rise in NPLs in Q2 which, given the high growth of credit, has allowed for further reductions in the NPL ratio. Recurring income has already begun to feel the effects but, for the moment, expenses have also adjusted downwards.

The downturn in banks' profitability has not so far translated into a reduction in their solvency. Indeed, in the first half of the year, solvency has slightly increased, highlighting the importance of the measures adopted in different areas by economic policymakers. Secondly, the recommendation not to pay out dividends has allowed banks to add these resources to their capital buffers, the numerator of the solvency ratio. Moreover, risk-weighted assets – the denominator of the solvency ratio – have diminished owing both to the use of the guarantees programme and to the rapid changes made to European capital regulations in late June. These were dubbed *Quick Fix,* and I shall refer to them later. The ECB's decisions, for their part, have helped bank financing conditions remain very loose.

But we should not be complacent here. As I said earlier, the foreseeable deterioration in assets will, according to our analyses, exert a significant impact on banks' solvency. Moreover, this impact will affect different banks in different ways, depending both on their starting position and on their exposure to the sectors most affected by this crisis.

In this connection, the ECB has recently conducted a forward-looking vulnerability analysis of the banks under its supervision to test their resilience to the shock caused by the pandemic. The results of this exercise, which I shall now refer to, are not very different qualitatively from the provisional results obtained at the Banco de España in the FLESB stress test exercise, whose final results will be published in our autumn *Financial Stability Report*.

First, under the baseline scenario of the vulnerability exercise, which incorporated the most likely effects of the crisis on macroeconomic variables, with cumulative declines in euro area GDP this year and in the next two years of around 1%, the reduction in overall European banks' solvency is estimated at 2 pp. It thus stands at 12.6% on average, above the established prudential requirements. Although there is heterogeneity across banks, these results highlight, first, that banks have faced this crisis with bigger margins of security, partly as a result of the regulatory changes made in the wake of the international financial crisis. Further, the results also show the effectiveness of the measures implemented to date to mitigate the impact of the crisis. These include most notably, in this area, the guarantee programmes, the ECB's extraordinary refinancing measures and the recommendation that banks should not pay out dividends, thereby reinforcing their resilience.

Under the more severe scenario, in which the decline in euro area GDP climbs to 6% up to 2022, the reduction in the solvency ratio is much greater (5.8 pp). That would leave average CET1 at 8.8% of risk-weighted assets. Moreover, under this scenario a significant percentage of banks would be below the minimum prudential requirements. As you know, the likelihood of this scenario occurring is low, but not negligible; accordingly, were it to materialise, it would be necessary to adopt additional measures to those already implemented. I shall return to this issue.

PUBLIC SECTOR: THE CRISIS WILL SIGNIFICANTLY DRIVE UP THE DEFICIT AND PUBLIC DEBT

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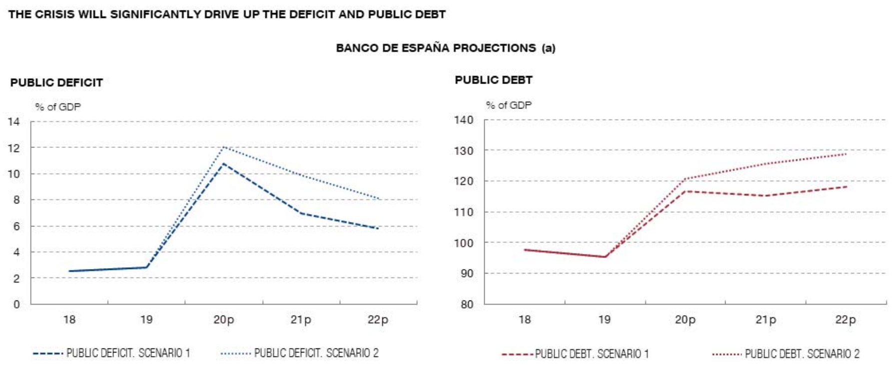

SOURCE: IGAE and Banco de España.

(a) Economic scenarios in the Banco de España projections published in September 2020. Scenario 1 envisages the emergence of fresh outbreaks; nevertheless, such outbreaks would only require containment measures of limited scope from a geographical standpoint and in terms of the sectors affected. Meanwhile, scenario 2 envisages more intense fresh outbreaks of the pandemic; however these would not require applying such strict and widespread confinement measures as those in force before lockdown began to be eased.

The latest developments in public finances in Spain reflect the impact of the pandemic and of the measures adopted to contain it. They have made for a significant increase in the **budget deficit and in public debt,** and in the contingent liabilities assumed by the different tiers of government. Specifically, general government debt rose in June to 110% of GDP (14.6 pp up on December 2019).

The Banco de España's macroeconomic projections augur a very marked worsening of the general government balance for 2020 as a whole and a partial correction in the two following years. Specifically, the debt ratio is expected to grow this year by more than 20 pp under scenario 1 and by around 25 pp under scenario 2, to 116.8% and 120.6% of GDP, respectively.

High public debt also entails vulnerability with a view to the future. In the short term, this risk has been mitigated, firstly, by the ECB's measures, which have prevented the fragmentation of euro area sovereign debt markets; and secondly, by the European response, with the launch of mechanisms to jointly tackle the costs of the pandemic. However, maintaining such a high level of public debt over time would expose the Spanish economy to a situation of chronic vulnerability to changes in financial market investor sentiment.

The Spanish economy's **external net debtor position** and external debt have risen, in terms of GDP, as a result of valuation effects and of the decline in output. Specifically, in 2020 Q2, the net debtor international investment position stood at 77.4% of GDP, 6.5 pp up on the previous quarter, influenced by the strong contraction in output. Spain's gross external debt stood at €56.8 billion in 2020 Q2, due solely to valuation effects, up to a record high of 188.1% of GDP. The Spanish economy's high debtor position continues to be a factor of vulnerability too, especially when set against the current high uncertainty over the future course of the economy.

Allow me to conclude this review of the risks to financial stability with a brief reference to the recent performance of the **financial markets** and, specifically, to their relationship to the aforementioned deterioration in non-financial corporations' credit quality.

SOME DISCONNECT BETWEEN FINANCIAL MARKET PERFORMANCE AND MACRO PERFORMANCE AND POSSIBLE RISKS DERIVED FROM MASSIVE CREDIT RATING DOWNGRADES, IN PARTICULAR FOR BBB-RATED FIRMS

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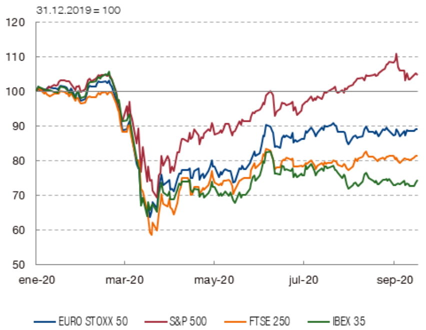
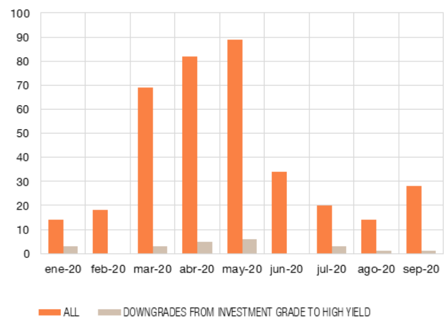
STOCK MARKET INDICES



SOURCES: Thomsom Reuters and Datastream.

CREDIT RATING DOWNGRADES IN THE EURO AREA



SOURCE: Thomsom Reuters.

Evidently, this crisis is also exerting a strong impact on the valuation of many financial assets, as well as on their volatility. Initially, stock markets underwent a strong adjustment and there was a marked increase in equity and bond volatility. Subsequently, following the global monetary and fiscal policy reaction, stock markets began to recover, and volatilities to fall. Indeed, in both the United States and the euro area certain market valuation indicators, such as the price-earnings ratio, have risen to record highs again. That might suggest a disconnect between the rapid and significant recent recovery in financial markets, and the more moderate trend of macroeconomic data and concerns over the weakness of the corporate sector

While the pace of credit rating downgrades has slowed in recent months, following the strong increase in the March-May period, the corporate spreads on high-yield debt (an external rating lower than BBB) saw their improvement interrupted both in Europe and in the United States. That prevented this debt security from reaching its pre-crisis levels once more, unlike investment-grade corporate debt (with an external rating of BBB or higher).

This worsening in corporate credit quality is an additional factor of vulnerability for financial stability. Past experience shows that across-the-board downgrades in the corporate sector can generate an adverse feedback loop, compounding crises. A recent analysis by the European Systemic Risk Board illustrates the importance of this vulnerability. It estimates that it is investment funds and insurance companies that amass most holdings of BBB corporate debt, one-third of which is associated with sectors considered to be coronavirus-sensitive. A massive downgrade of these companies' ratings, leading them to lose their investment-grade status, would mean potentially substantial losses for the European Union's overall financial system.

The role rating agencies play in this process is fundamental. In their valuations, then, these agencies should take into account the long-term outlook for companies and avoid excessively procyclical behaviour. In fact, on this occasion the rating agencies have apparently been more cautious than in the global financial crisis and, to date, there have been no phenomena comparable with those in the past. In any event, the results of this exercise demonstrate the systemic significance of this vulnerability and the need to be ready to offer a sufficient and internationally coordinated response, depending on how the pandemic evolves globally.

2 The economic policy reaction

ECONOMIC POLICIES HAVE REACTED RAPIDLY AND FORCEFULLY TO ADDRESS THESE RISKS

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1. **Monetary policy**:
    - Funding for banks under very favourable conditions to promote the provision of bank lending.
    - Increase in the volume of asset purchases in order to ease financing conditions in debt markets and prevent their fragmentation.
2. **Fiscal policy**:
    - Moratoria on tax payments.
    - Employment furlough scheme with advantageous conditions.
    - Public guarantee programme for loans.
    - European reconstruction fund.
3. **Financial policies**:
    - Delay in the calendar for implementation of Basel III.
    - Use of flexibility in accounting standards.
    - Release of macroprudential buffers and announcement of extended periods of time for their replenishment.
    - Quick Fix and relaxation of capital and liquidity regulation.
    - Recommendation to temporarily eliminate the payout of dividends and to apply prudence in variable remuneration.

In the rest of my address I shall analyse the economic policy response during this crisis, and how this response should now be tailored to the latest pandemic-related developments and their economic effects.

On the **monetary policy** front, almost seven months have elapsed since the ECB began deploying an extensive raft of measures aimed at mitigating the impact of the pandemic on the European economy. The ECB adopted a series of measures that can be grouped in two major blocks. First, those geared to promoting the provision of bank lending to the real economy. Here, the ECB approved a range of measures providing liquidity to banks, so that banks in turn could preserve households' and firms' access to credit. Second, the ECB approved a second block of measures, relating to the asset purchase programmes. Specifically, we announced the launch in March of a new pandemic emergency purchase programme (PEPP), with an initial €750 billion envelope for 2020 as a whole. This was extended in June both in terms of the period over which it would run (at least until June 2021) and of its volume (with an extra €600 billion, making for a total of €1.35 trillion). Furthermore, the programme gives the ECB the necessary flexibility to be able to concentrate its purchases at specific points in time or in government bonds issued by certain jurisdictions, so as to avoid the fragmentation of monetary policy transmission.

As of today, we can say that the PEPP has been clearly successful in checking the deterioration in financial markets in all euro area countries. This is particularly visible in how sovereign debt yields have trended, as they stand today at close to pre-crisis levels. But it is also discernible in other market segments, such as that of corporate issuers.

This fall in the cost of sovereign debt has increased the room for manoeuvre of the fiscal authorities in all the area's countries, enabling them to roll out unprecedented income support measures for households and firms. And this is particularly important because, as I have said on several occasions, **budgetary policy** is the main means of defence we have, from the economic policy standpoint, to combat the consequences of COVID-19.

This instrument has been used decisively since the crisis broke, in Spain and in other countries. On one hand, budgetary allocations have been increased in the health area to tackle the pandemic. And on the other, since before the lockdown in the economy, various measures aimed at compensating for the loss of labour income and business revenues have been deployed. I might specifically mention the employment furlough schemes and the programmes granting public guarantees to financing by credit institutions to firms, which I referred to earlier. As you are well aware, the aim of these measures is to provide for the continuation of employer-employee relationships once the measures restricting activity and personal movement have been withdrawn. They strive also to maintain the viability of non-financial corporations which, though solvent, have seen their liquidity position worsen as a result of the crisis.

The **fiscal policy** response here has not on this occasion been exclusively national, but also European, with the approval, in particular, of the European reconstruction fund. Such European action is particularly significant in the context of the Monetary Union, given the degree of integration of all the economies in the area. That means that joint action is much more effective in combating the effects of the crisis. The approval of the reconstruction fund has, at least temporarily, helped make up for the absence of a common European macroeconomic stabilisation instrument.

The third area of action during the crisis has been that taken by the various authorities with financial prudential competencies, which have also adopted numerous decisions with the principal aim that the financial system should contribute to overcoming the crisis. Firstly, supervisory processes have been adapted to release banks' operational resources. In this respect, the Basel Committee on Banking Supervision has decided to delay by one year the implementation of Basel III. Secondly, aspects of the accounting regulations in force for calculating credit risk have been clarified, with the aim of preventing excessive procyclicality. The authorities have also proceeded to release most of the macroprudential capital buffers that they had set up, in many cases in response to the build-up of systemic risk in their economies. It has also been announced that banks will be given long enough time to subsequently replenish these buffers if they are used. The financial authorities have recommended that banks temporarily eliminate the payout of dividends and that they apply prudent criteria for the variable remuneration of employees, so they may channel the resources they generate towards strengthening their capital positions. Finally, capital requirements regulations have been reformed by means of the so-called "quick fix". The fix includes permanent measures, such as adapting the SME support factor in the calculation of risk-weighted assets, and temporary measures, such as the application of a prudential filter to changes in the value of sovereign debt instruments. As a result, banks' shock-absorption capacity has been enhanced and, in turn, assistance has been given to financing to firms and to the investments that may be most affected.

One aspect worth underscoring about the economic policy response to date is the **high degree of complementarity there has been between the actions of different authorities**. If the ECB response and the decisions of the European Council have helped increase governments' fiscal room for manoeuvre, governments' action and that of the ECB itself has been crucial for ensuring liquidity and reducing the risks to non-financial corporations. Along with the decisions of the micro- and macroprudential authorities and the ECB, all these actions have allowed credit to continue flowing to economic agents. It will be very important to maintain this degree of complementarity in the future.

3 An economic policy to manage current and future challenges

OPTIMAL ECONOMIC POLICY RESPONSE IN A SETTING OF INCREASINGLY SCARCE PUBLIC RESOURCES

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1. **Maintenance and even extension, where necessary, of support measures:**
   - Budgetary policy of sustaining household and corporate income.
2. **Measures now more focused on the sectors and population groups most affected**
3. **Early identification of structural changes:**
   - Smoothing the adaptation of the productive system and its workers to the new reality and the efficient cross-sectoral and cross-firm reallocation of resources.
4. **Modification of the instruments supporting firms to avoid greater corporate debt:**
   - Modifying debt restructuring and insolvency regulation.
5. **Pressing need to define an ambitious structural reform agenda**
6. **European funds: we must ensure that they are earmarked for projects and structural reforms that improve the economy's potential growth:**
   - This should serve as the groundwork for creating a permanent, common European stabilisation mechanism.
7. **Design of a credible strategy for the gradual and sustained reduction of fiscal imbalances, to be implemented once the recovery is firm.**

As I said at the outset, the current macroeconomic setting is characterised by a partial, uneven, fragile and uncertain recovery in which the greater than initially expected persistence of the crisis is patent.

In parallel, certain structural damages are coming to light. These include most notably: the increase in public and private sector debt; the partial destruction of the productive system (as seen by the fact that the number of Social Security-registered firms has fallen most appreciably since the start of the crisis, with 84,000 fewer firms between end-February and end-September, representing a decline of -6.1% year-on-year); the loss of effective employment and the risk that the persistence of the crisis will convert this into long-term unemployment; and, finally, increased inequality stemming from the fact that the recession is affecting low-wage workers in a more fragile financial situation to a much greater extent.

There are also signs that the pandemic is causing certain structural changes in consumption and economic activity patterns. Cases in point are those arising from the increase in remote working and, generally, the greater use of new technologies in numerous areas. Along these same lines, this crisis has highlighted certain vulnerabilities associated, for example, with the ongoing global fragmentation of production, which may prompt significant changes in trade relations between countries in the coming years.

Against this backdrop, the question is what the optimal economic policy response should be, especially in a setting of increasingly scarce public resources. The response should involve a combination of short-term measures with a long-term strategy. It should provide certainty and enable the structural challenges pre-dating the pandemic to be tackled urgently, along with those caused by the crisis. The strategy is, moreover, relevant in monetary, financial and fiscal areas alike, and applies both to European and to domestic policy.

First, it seems wise to **maintain – and even extend, where necessary – the support measures**. Their premature withdrawal would cause harm going beyond the possible costs of maintaining them until the recovery can be seen to be solid enough. This affects both the budgetary policy of sustaining household and corporate income, and financial and monetary policy.

Second, as regards fiscal policy, **the measures should now be much more focused** on the sectors and population groups most affected. This is the case, for instance, of the recent pact between the Government and social agents to renew furlough schemes until 31 January 2021.

Third, **the early identification of structural changes is crucial**. Economic policy cannot indefinitely sustain a sector whose level of activity, structurally, is going to decline. In the face of the structural changes, economic policy should be geared to smoothing and supporting the adaptation of the productive system and its workers to the new reality, and to the efficient cross-sectoral and cross-firm reallocation of resources. This means that, in the case of firms with non-viable business models, the way should be cleared for their orderly exit from the market. And in the case of firms facing structural reductions in demand, it must be ensured that the various flexibility mechanisms companies have in the current labour market framework work properly. Naturally, too, there must be an emphasis on employee training policies to smooth their switch to sectors with a future.

Fourth, **the structural damage caused by the pandemic needs to be tackled**. For example, in the case of the increase in corporate debt, it would be worth modifying the instruments supporting firms, so that they do not entail an increase in financial liabilities. Direct aid or temporary capital injections may be more effective instruments now for viable companies. And, in parallel, so that these viable firms may confront difficulties and meet their financial obligations, the functioning of debt restructuring procedures should be swifter and smoother. To attain these objectives, it would be advisable to improve the workings of judicial and out-of-court insolvency procedures, making them more efficient and flexible.

Fifth, **there is a pressing need to define an ambitious structural reform agenda**, aimed at increasing the economy's potential growth, which was already low prior to this crisis. Our economy faces a very wide range of challenges. We must address lacklustre productivity, the duality of the labour market, high unemployment, population ageing, inequality, combating climate change, changes in the globalisation model and expediting the digitalisation of the economy.

Sixth, we must **ensure that the use of European funds is earmarked for projects and structural reforms capable of improving our economy's potential growth**. **And European action should also be aimed at plugging existing institutional gaps** (in particular, the creation of a permanent, common macroeconomic stabilisation mechanism, the deepening of the Capital Markets Union and, as I shall stress later, the completion of the Banking Union).

Seventh, we **need to design a credible strategy for the gradual but sustained reduction of fiscal imbalances,** to be implemented once the pandemic is behind us and the economic recovery is entrenched. This strategy is particularly relevant and suitable for a country, like Spain, that has faced this crisis from a more vulnerable public finances position than our European peers.

This strategy would have significant benefits. The reforms would help lead to an increase in our economy's potential growth and enhance the credibility of public finances being sustainable in the medium term. That would, in turn, increase the fiscal headroom available and boost the expansionary effects of the current fiscal measures. In sum, we must give ourselves the necessary fiscal space to increase the support measures for the economy should the course of the pandemic so require it. To do so, we must resolutely implement the reform agenda, lay down fiscal consolidation plans and reform the support instruments to make them more flexible and focused.

MONETARY AND FINANCIAL ASPECTS OF THE ECONOMIC POLICY RESPONSE BANCO DE ESPAÑA Eurosistema

- **Response at the European level to avoid a financial component in the crisis**
  - Completion of the Banking Union (common European Deposit Guarantee Scheme), harmonisation of winding-up regimes, adaptation of the Resolution to systemic crises, development of the Capital Markets Union, etc.
- **Credit institutions**
  - Proper recognition of the effective impairment of the quality of their credit exposures.
  - Very prudent dividend payout and remuneration policies.
  - Improvement in efficiency.
- **Response at the international level**
  - Keep in place the anchor that the financial regulation approved in the past decade has represented. Full, consistent and timely transposition of Basel III regulations by all jurisdictions.
- **Monetary policy**
  - Retain a significant monetary stimulus until the recovery is firm, and even increase the stimulus, were it necessary.
  - Retain flexibility in the implementation of asset purchase programmes.
  - Review of monetary policy strategy.

On the financial front the **aim**, as I said, **is that under no circumstances should the health crisis that has become an economic crisis ultimately give rise to a financial crisis**. Here, as is the case in the monetary and – incipiently so – fiscal areas, **in the banking context the response to the possible materialisation of these risks can only be European**, given the commitment to the Banking Union. In any event, at the European level the response to the current scenario should include the culmination of the Banking Union. And we should also see the approval of a fully pooled European deposit guarantee scheme, given that this would be a decisive contribution to ensuring financial stability in the euro area. A further priority is to analyse the suitability of European resolution regulations faced with a hypothetical systemic crisis or the possible role of asset management companies in the event of the serious impairment of European financial institutions' balance sheets. The EU Member States should also move swiftly to reach an agreement on the creation of a common European procedure for the winding-up of credit institutions. In Spain, recent experience shows the current insolvency proceedings for credit institutions to be rather inefficient in terms of timelines and recoverable amounts.

Banks, from their standpoint and in the event of the crisis being prolonged, must firstly ensure proper and timely recognition of the effective impairment of the quality of their credit exposures by means of compliance with supervisory guidelines. Moreover, their dividend payout and remuneration policies should continue to be very prudent until the current uncertainty abates and a sound economic recovery takes root. Banks must also strive to improve their efficiency and make the necessary investments in digitalisation and information use, while expanding their most profitable activities and keeping the risks assumed under strict control. This is particularly important in a setting in which low interest rates are foreseen for a very lengthy period and bearing in mind that the current crisis may increase the advantages of some high-tech competitors.

Consolidation processes in the banking industry, for which some scope remains, can help strengthen banks and the system as a whole. But they should be analysed on a case-by-case basis and properly executed, so as to harness potential synergies. Our role as banking supervisors is to analyse the viability and oversee the execution of the merger projects submitted, from the standpoint of the viability of the business and, therefore, of the solvency of the resulting institution, all while having regard to overall financial stability.

Lastly, at the international level, the anchor that is the financial regulation approved in the past decade must be kept in place. In particular, as recently agreed on the Basel Banking Supervision Committee, all jurisdictions should pursue full, consistent and timely transposition under the new calendar for the Basel III regulations.

With regard to monetary policy, the fragility and unevenness of the euro area recovery, forecast medium-term inflation that is far below our objective and a nominal effective exchange rate that has countered much of the stimulus we provided all lead to a single conclusion: there is no room for complacency. **We must retain a significant monetary stimulus until we are certainly the recovery is firm. Moreover, we cannot rule out the need to recalibrate the foregoing measures, or to introduce new ones were it necessary,** in order to fulfil our price stability mandate, this always being understood symmetrically. In this connection, we should make it clear that inflation of 1.3%, like that projected by the ECB for the 2022 horizon, is not compatible with the ECB's inflation mandate. It is also crucial to retain flexibility in the implementation of our asset purchase programmes to prevent financial fragmentation problems emerging.

Beyond the short-term response, we have at the ECB launched a review of our monetary policy strategy in order to address the challenges we face. These are, specifically, those stemming from the low-inflation environment, the reduced scope of conventional instruments and the structural role of non-conventional instruments. Given that this process is ongoing, I cannot foretell what its conclusions will be. But I can say it is an open process. Both the ECB and the national central banks of the Eurosystem are conducting many analyses and gauging the opinion of citizens, academia and other professional and social groups.

I can also anticipate that one of the key aspects of this review will concern the definition of price stability. The current inflation objective, consisting of a rate lower than but close to 2%, is liable to be reformulated. On one hand, it may be necessary to clarify the specific level of inflation it is sought to attain, to make it easier for economic agents to understand. On the other, in line with my previous comments, it might be possible to make this objective more symmetrical, making it clear that the degree of tolerance to inflation slippage above the objective will be the same as when inflation deviations are below it. Also, in the current setting of low inflation and interest rates close to their lower bound, the inflation objective will have to take into account the need to allow a sufficiently sizeable cushion above zero, providing more room for manoeuvre for conventional interest rate policy.

In short, **the ultimate aim of this monetary policy strategy review should be to strengthen the effectiveness of monetary policy in the euro area and its capacity to achieve its objectives in the macroeconomic environment of the coming decade.**

4 Conclusion

To conclude, I should like to stress what, from my standpoint, the main contribution of economic policy should be in the face of an environment as complex as that we are currently experiencing. This contribution should consist of providing certainty to economic agents and supporting the recovery, but also smoothing the structural adaptation of the economy and taking a long view.

In Spain's case, this objective is twofold. First, it calls, beyond short-term measures, for the urgent application of the structural reforms needed to increase our economy's potential growth; and second, for the timely design of a fiscal consolidation programme – to be gradually applied once the recovery has firmed – that ensures the sustainability of public finances. For this strategy to be credible and offer real certainty, consensus among the various agents (political, economic and social alike) is required to ensure the effectiveness of the necessary measures and their durability over time.

Thank you for your attention.