Foreword by the Governor Pablo Hernández de Cos

The COVID-19 pandemic is exacting a very heavy cost in human lives despite the extraordinary measures adopted to contain its spread. It has also caused far-reaching disruption to society and the global economy in recent months. As a result, the dynamics of the global and Spanish economic environment in late 2019 and early 2020 were abruptly altered. And this year, the level of activity will foreseeably contract on a scale never before witnessed in peacetime.

Against this background, the Banco de España Annual Report 2019 focuses singly on the unfolding of the health crisis, its initial economic impact and the economic policy measures deployed to restrict its adverse effects. Chapters 2, 3 and 4 of the Report address these aspects from a global, European and Spanish perspective. The fifth and final chapter analyses in detail the main challenges the Spanish economy must tackle in the medium term and what, in the Banco de España's view, the guiding principles of the economic policy response should be.

As I recently had the opportunity to set out before Parliament,[1] many of our economy's current challenges were already present before the health crisis broke, though the current circumstances have increased the scale of the threat they pose and the urgency of responding to them. The pandemic has also given rise to new challenges whose magnitude and consequences are still very uncertain. How economic policy addresses these challenges will determine the intensity and sustainability of Spain's economic growth and social well-being in the coming years.

Naturally, the economic policy response to this crisis should adapt to how the pandemic unfolds healthwise. Initially, the measures to contain the disease involved, in most countries affected, the shutdown of a wide range of sectors of activity. At that juncture, the severity and the temporary and global nature of the shock warranted the implementation of forceful, time-limited and internationally coordinated economic policy actions.

Indeed, Chapter 3 of this Report shows how the economic authorities in different areas and regions have in recent months applied a type of shock therapy. Their

1 See the appearances by the Governor before the parliamentary committees for Economic Affairs and Digital Transformation on 18 May 2020, and for the Social and Economic Reconstruction of Spain after COVID-19 on 23 June 2020.

essential aim has been to prevent what is an eminently temporary health shock from ultimately causing persistent harm to the economy's growth and recovery capacity.

Within the euro area, the European Central Bank has launched a raft of anti-crisis emergency measures. These have been crucial in alleviating financial tensions and maintaining the flow of financing to the economy. They have also provided considerable headroom to the fiscal authorities in their fight against the pandemic and its economic effects. As a matter of fact, the response of national fiscal policies has likewise been robust. It is this strand of economic policy that has the most appropriate instruments to combat the crisis with immediate and focused measures, which can and must be tailored to the still-uncertain duration of this situation and to the differing effects the crisis will have on different population groups and productive sectors.

At the European level, we must acknowledge that, even with the support of monetary policy, national authorities alone can hardly face down the challenges posed by this shock. Given the deep-seated economic and financial interactions among the various euro area countries, joint action is the most effective way to ensure that the economic effects of the pandemic are overcome promptly and at a lower cost for each and every member. Following an initial, muted response by the European Council, a European Commission proposal to create a European recovery fund is now under discussion. It is imperative that we approve this fund as soon as possible, and that it should be of a size proportionate to the financing needs generated by the pandemic.

In recent weeks we have moved into a second phase of the crisis. In a setting in which the disease is more under control, it has been possible in Spain and other countries to start rolling out lockdown easing plans. This second phase, in which the economy begins gradually to pick up, has some significant features. First, uncertainty remains very high, as there are numerous doubts over the path the disease will follow in the coming months. This uncertainty will adversely affect consumption and investment decisions, and also international economic transactions. Second, minimising the risk of a fresh outbreak of the disease will mean we will have to retain some restrictions and health safety measures. These circumstances, which will condition the normal pursuit of economic activity, will affect the different productive sectors unevenly. Third, we will begin to discern in this phase to what extent the crisis, despite the economic policy measures taken, may be harming our productive system and, therefore, our growth capacity more permanently. We will also begin to see some signs of the possible structural changes that may stem from the pandemic, e.g. in terms of a transformation to the ongoing globalisation and digitalisation marking the world economy in recent decades.

In this period, the economic policy response must encompass two objectives: to support the recovery, which advises against a premature withdrawal of the support measures, since that would raise the risk of economic growth undergoing more lasting damage; and to smooth the economy's adjustment to the post-pandemic scenario.

In the area of monetary and financial policies, to whose European-level decisions the Banco de España contributes as part of the Eurosystem and Single Supervisory Mechanism, the priority is clear: to continue giving support to the recovery; to provide appropriate financing conditions for the different economic agents; and to preserve financial stability. In this connection, and in relation to monetary policy, we have on the ECB Governing Council reiterated our commitment to do what it takes to support the euro area economy at this extremely difficult juncture. This includes ensuring that the Eurosystem's monetary policy is properly transmitted to all sectors of the economy and all countries, and preventing the financial fragmentation of the area. In this respect, we stand ready to adjust all our instruments as needed.

On the supervisory front, the banking sector is facing this crisis from a healthier position than in the previous recession. That highlights the importance of the far-reaching global financial reform undertaken in the past decade. In any event, it will be necessary in the coming months to be doubly watchful: first, of banks' ability to continue providing the financing that firms, the self-employed and households need; and further, of the risks to financial stability arising from this crisis.

Regarding the ability to provide financing, we supervisors have adopted several decisions which, among other matters, allow banks to continue using the capital and liquidity buffers at hand. Moreover, most European governments, including Spain's, have approved public guarantee programmes backing loans to firms. These are geared to mitigating the possible reluctance of financial intermediaries to incur greater risks in a setting such as the present, and to helping pave the way for many SMEs and sole proprietors to continue raising finance in these difficult times. So far, these measures have been effective in terms of keeping lending in Spain buoyant. Chapter 4 of the Report attests to this, as do the data from recent months, which evidence a strong increase in the flow of new lending granted by banks to firms in Spain.

While the current high level of uncertainty persists, small firms and those most affected by the crisis might encounter difficulties gaining access to financing, especially in the absence of public support instruments. In terms of how economic activity evolves, that would advise studying the possibility of extending the public guarantee mechanisms already in place. In re-designing such mechanisms, priority of access to funds should be for firms with sound prospects of viability, with a view to smoothing the necessary cross-firm and cross-sectoral reallocation of productive resources.

The crisis will also significantly impact the quality of banks' credit portfolios. The effect across banks will be uneven, depending on their starting position, their business model and the distribution of their exposures to the sectors and territories most affected by the pandemic. The scale of the shock and its uncertain path thus obliges us to monitor closely the risks to financial stability arising from this crisis. We must be ready to provide a forceful, pan-European response should these risks materialise.

Hence, all economic authorities, European and national alike, must share the same goal. We must ensure the current crisis is not accompanied by an across-the-board tightening of financing conditions and that it does not seriously damage the financial system's stability. Well are we aware that crises incorporating a significant financial downturn are usually deeper and more durable.

Turning to domestic policies, some of the measures already applied should be temporarily extended and recalibrated. Along with the recently approved extension of short-time work arrangements (ERTEs) until end-September, it seems appropriate to retain some of the support instruments for the most vulnerable households. It is essential, however, that such instruments remain focused, and designed so as not to distort, for instance, labour market participation decisions. In parallel, the proper functioning of the different working flexibility mechanisms available for firms should be ensured. Their role is especially useful in these circumstances for enabling the adjustments derived from the crisis to be made.

At the same time, it would also be advisable to incorporate new measures into various areas. Active labour market policies and training policies for the unemployed and for workers affected by ERTEs should, once suitably redesigned, be geared to boosting employability and to providing for the relocation of workers most affected by the crisis to those sectors or firms with most growth capacity. Also, the suspension of face-to-face education runs the risk of adversely affecting students' academic performance, particularly in less well-off households. Consequently, the education system should have the mechanisms enabling it to allow all students to acquire the necessary skills and qualifications, even in the absence of presence-based classes. Likewise, there is a pressing need to review firms' restructuring, insolvency and financial burden-alleviation processes, in order to set nimble, simplified administrative procedures in place. Specifically, debt-laden firms with financial difficulties should be able to move into a preventive framework enabling them to continue to pursue their business activity while they are still viable.

The economic policy response in this second phase of the crisis must also count on the resolute support of the European Union. By means of an additional EU fiscal impulse to that each Member State deploys, it can then support the restructuring of the European productive system and the recovery of its growth capacity. It would be advisable here to prioritise the use of the aforementioned European recovery fund for specific investments that usually contract more at times of uncertainty and financial difficulty. Such is the case of investment in technological capital and in training. The time is also right to promote projects contributing to the transition to a more environmentally sustainable economy. Approving and rolling out this European fund should be done as swiftly as possible. Its design should likewise provide for the possibility of an increase in its size, depending on how the crisis evolves. Further, the fund should be the precursor to a permanent fiscal mechanism for pan-European macrofinancial stabilisation.

We should look beyond the policies needed in this phase of incipient economic recovery. Taking a longer view, the setting envisaged in the latest Banco de España projections (and those of most analysts) for the coming years is extraordinarily complex. It will call for the definition of a reform agenda to tackle our economy's increasingly pressing (because of the crisis) structural challenges. Moreover, insofar as the post-pandemic Spanish economy will have its highest levels of public debt in many decades, partly due to the necessary fiscal expansion in the short term, it is also imperative to design a plan to redress public finances in the medium term. Otherwise, persistently high public debt/GDP ratios will leave us chronically vulnerable ahead of any adverse macrofinancial shocks in the future. Chapter 5 of this Report addresses these and other priority aspects for positioning the Spanish economy on a sustainable growth and job-creation path once more.

One of the most visible challenges concerns the need to raise productivity. That requires increasing public and private investment in human and technological capital, reviewing the educational model, and promoting business growth and dynamism. Labour market duality and a very high structural unemployment rate do not only limit growth capacity; they also contribute to increasing inequality. We must undertake forthwith a review of active employment policies and those aspects of the current labour market regulatory framework that lead to excessive disparity in the degree of protection afforded to permanent as opposed to temporary employees. It is the latter who have borne the brunt of job destruction during the first phase of this crisis, as has recurrently been the case in previous recessions. These reforms, along with income support measures such as the now-approved Minimum Income Scheme, should contribute to reducing inequality in Spain. Inequality levels, which were higher at the onset of the pandemic than at the start of the 2008 crisis, will probably rise further in the coming quarters, given that this crisis is affecting to a greater extent groups that generally have relatively lower income.

Nor can we forget ongoing population ageing. Among other aspects, this phenomenon will most appreciably influence the behaviour of the labour market, growth dynamics and the main fiscal variables in the coming decades. Once the crisis is behind us, public finances must gradually restore their room for manoeuvre by means of a credible multi-year consolidation plan. Reducing the vulnerability of our economy also requires further boosting progress in the institutional design of the euro area, moving towards a fully fledged Banking Union, the Capital Markets Union and, more generally, greater euro area-wide risk-sharing.

In any event, with every challenge there are new opportunities. The Spanish economy must be flexible and proactive in harnessing the new possibilities arising from the fight against climate change and the transition to a more sustainable economy, from the changes in the globalisation model and from the foreseeable acceleration in digitalisation in the economy. The analyses conducted in this Report and the assessments made of the evidence garnered nationally and internationally seek to contribute actively to the collective debate on these issues of vital interest to the Spanish economy.

To address these challenges, we urgently need an ambitious, comprehensive, permanent and assessable structural reform and fiscal consolidation strategy for Spain. This strategy must be ambitious if we genuinely seek to lay the foundations for more sustainable and balanced growth in the future. The design and implementation of the reforms should be pushed swiftly through, since their credible formulation may positively affect spending, investment and hiring decisions, even in the very short term. Fiscal consolidation, for its part, must be applied once the economy is on a sound growth path again. But its definition and prompt communication can significantly benefit the credibility of our economic policy. This strategy must also be comprehensive in nature, encompassing the numerous interactions between the challenges to be tackled which, in many cases, require measures at the international and, in particular, European level. Accordingly, the guiding principles of this strategy must command considerable consensus among the various political, economic and social agents, so that the foundations underpinning our growth may be stable. Finally, any strategy conceived with a medium-term horizon should be rigorously and continuously assessed with a view to identifying areas for improvement in its design or in its application. Adopting this culture of assessment in economic policy design and implementation should be one of the pillars of the growth strategy for the Spanish economy.

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Foreword to the *Annual Report 2019*.

30 June 2020.