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

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GOVERNOR

This paper is an extended version of the initial testimony by the Governor of the Banco de España before the Parliamentary Committee for the Economic and Social Reconstruction of Spain after COVID-19.

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Abstract

The COVID-19 crisis has elicited an immediate and forceful economic policy response. With the height of the crisis behind us, the Governor has set out priority economic measures for the post-lockdown phase. He calls for the urgent launch of an ambitious, comprehensive, permanent and assessable strategy of structural reforms and fiscal consolidation.

In this second, gradual-recovery phase, laying the foundations for sustainable and balanced growth will involve the economic policy response combining two objectives: to support the recovery and to provide for structural adjustment. And, in this scenario, public finances sustainability must be ensured.

Three elements are needed to boost the credibility and effectiveness of this initial response and of the entire reform strategy. First, the fiscal expansion in the short term should go hand-in-hand with a plan to restore health to public finances in the medium term, once the economy resumes a sound growth path. Second, structural reforms should be expedited so they positively affect spending, investment and hiring decisions in the very short term. And third, political consensus must ensure the durability of the strategy over several legislatures.

In the short run, the policies supporting the recovery should be attuned to the health situation and economic circumstances. That will involve maintaining monetary and financial measures geared to preserving appropriate access to financing. It will further entail extending and recalibrating income support and furlough schemes. New measures will also be needed, namely: active labour market and training policies for the unemployed; enhanced business restructuring and insolvency procedures; and a fiscal impulse for the restructuring of the productive system through investment in technological capital, education and training.

In the medium term, the Spanish economy's main challenges will determine the structural reform agenda needed to increase our potential growth over the coming years. The paper details the measures on this agenda in response to each of the challenges identified: i) to improve productivity dynamics (promotion of business dynamics and growth, increased sectoral competition, enhanced human capital and an increase in technological capital); ii) to reduce unemployment and job insecurity (with a lower temporary employment ratio and active labour market policies); iii) to address population ageing (pensions system reform); iv) to bolster inclusion policies (minimum living income and housing affordability); v) to smooth the transition to a more sustainable economy (via fiscal policy and the financial system); vi) to maintain a healthy financial sector; vii) to tackle new challenges (globalisation and digitalisation); viii) to drive forward European governance reform (an appropriate European recovery fund, headway in the fiscal union, Stability and Growth Pact reform, completion of the Banking Union and a genuine Capital Markets Union); and ix) to ensure the sustainability of public finances (an ambitious multi-year fiscal consolidation programme).

Keywords: post-pandemic scenario, economic policies, strategic priorities, economic recovery, structural adjustment, fiscal consolidation, reform agenda, potential growth, labour market policies, human and technological capital, inclusion policies, sustainable economy, European governance, globalisation, digitalisation.

JEL classification: E60, E61, E65, E66, E44, E62, E64, E58, J1, J3, J38, I0, I2, F55, I140, I15, Q5.

Resumen

Una vez superada la etapa más aguda de la crisis del Covid-19, que ha supuesto una respuesta inmediata y contundente de la política económica, el gobernador plantea las medidas económicas prioritarias en la fase siguiente a la hibernación y la puesta en marcha, de manera urgente, de una estrategia ambiciosa, integral, permanente y evaluable de reformas estructurales y de consolidación fiscal.

En esta segunda fase de reactivación paulatina, la respuesta de la política económica, para sentar las bases de un crecimiento sostenible y equilibrado, tiene que combinar dos objetivos: apoyar la recuperación y facilitar el ajuste estructural. Y, en ese escenario, la sostenibilidad de las finanzas públicas debe estar garantizada.

Para potenciar la credibilidad y efectividad de esta respuesta inicial y de toda la estrategia de reformas: i) la expansión fiscal en el corto plazo debe presentarse acompañada de un plan de saneamiento de las cuentas públicas en el medio plazo, que procederá cuando la economía recupere una senda de crecimiento sólido; ii) las reformas estructurales deben acelerarse, para generar efectos positivos a muy corto plazo sobre las decisiones de gasto, inversión y contratación; iii) el consenso político debe garantizar la permanencia de la estrategia durante varias legislaturas.

En el corto plazo, las políticas de apoyo a la recuperación deberán acomodarse a la evolución de la situación sanitaria y la coyuntura económica. Ello supondrá mantener medidas monetarias y financieras orientadas a preservar el acceso adecuado a la financiación, extender y recalibrar el sostenimiento de rentas y expedientes de regulación temporal de empleo, nuevas medidas, como políticas activas de empleo y de formación de los desempleados y mejores procedimientos de reestructuración e insolvencia empresarial, y un impulso fiscal a la reestructuración del tejido productivo a través de la inversión en capital tecnológico, educación y formación.

En el medio plazo, los principales desafíos de la economía española inspiran la agenda de reformas estructurales que debe aumentar nuestro crecimiento potencial en el escenario de los próximos años. En el texto se detallan las medidas contenidas en esta agenda en respuesta a cada uno de los retos identificados: i) mejorar la dinámica de la productividad (fomento de la dinámica y el crecimiento empresarial, aumento del grado de competencia sectorial; mejora del capital humano e incremento del capital tecnológico); ii) reducir el desempleo y la precariedad del empleo (con menor temporalidad y políticas activas de empleo); iii) afrontar el reto del envejecimiento poblacional (reformas del sistema de pensiones); iv) reforzar las políticas de inclusión (ingreso mínimo vital y acceso a la vivienda); v) favorecer la transición hacia una economía más sostenible (desde la política fiscal y el sistema financiero); vi) mantener un sector financiero saneado; vii) afrontar los nuevos retos (globalización y digitalización); viii) impulsar la reforma de la gobernanza europea (un fondo de recuperación europeo adecuado, avances en la unión fiscal, reforma del Pacto de Estabilidad y Crecimiento, culminación de la Unión Bancaria y una verdadera Unión de Mercados de Capitales); ix) garantizar la sostenibilidad de las cuentas públicas (un ambicioso programa de consolidación fiscal plurianual).

Palabras clave: escenario pos-Covid-19; políticas económicas; prioridades estratégicas; recuperación económica; ajuste estructural; consolidación fiscal; agenda de reformas; crecimiento potencial; políticas de empleo; capital humano y tecnológico; políticas de inclusión; economía sostenible; gobernanza europea; globalización; digitalización

Códigos JEL: E60, E61, E65, E66, E44, E62, E64, E58, J1, J3, J38, I0, I2, F55, I140, I15, Q5.

Contents

1 Introduction

I appear before this Committee for the Social and Economic Reconstruction of Spain after COVID-19 to set out what should be the guiding principles, in the opinion of the Banco de España, of Spain's economic policy strategic priorities. The aim ahead is to promote a prompt recovery of the Spanish economy and lay the foundations for higher, more sustainable and balanced growth.

Before elaborating on these priorities, allow me to convey my praise and gratitude to Spanish citizens for their exemplary behaviour in the especially difficult circumstances we have faced in recent months. Naturally, my support also goes out to all those who have lost loved ones as a result of the pandemic.

As you are all aware, the crisis arising from the COVID-19 pandemic has disrupted economic activity on a massive scale, not only in Spain but also globally. To such an extent that, on all available forecasts, this year will probably see the biggest declines in GDP recorded in peacetime. Indeed, the scenarios with more moderate declines in activity, projected just a month back, have already been ruled out. This is because the current adverse shock, while temporary in nature, is proving more durable than we initially anticipated.

As I argued in my appearance last May before the Parliamentary Economic Committee,[1] the severity, temporariness and global nature of this shock initially warrant forceful economic policy measures, monetary, fiscal and prudential alike. These should be time-limited – until employment and economic activity regain momentum following the lockdown imposed – and internationally coordinated.

The goals of this shock therapy should be to lessen the effects of the pandemic in the short term and provide for an exit from the lockdown of the past few months with the least economic harm possible, to prevent a temporary shock from causing persistent effects over time. Broadly, the response of the authorities – with measures I described and assessed in the aforementioned appearance – has been significant.

Following the shutdown, a second phase now ensues. The economy, as the available indicators suggest, is gradually beginning to recover, in step with the lockdown-easing measures laid down by the Government. However, this second phase is, firstly, marked by still-high uncertainty. There remain many unknowns as to how the disease will unfold in the coming months and which will determine at what pace our everyday lives and, therefore, economic activity, resume normality. It is highly likely this uncertainty will adversely affect consumption and investment decisions and international trade flows for a long time.

Second, minimising the risk of a fresh outbreak of the disease will mean retaining certain restrictions and health safety measures for a time that is difficult to predict. These

1 See P. Hernández de Cos (2020), Appearance before the Parliamentary Economic Affairs and Digital Transformation Committee, 18 May 2020.

will condition the normal pursuit of economic activity and will affect the various productive sectors unevenly.

Third, the uneven effects of the crisis on different sectors, types of firms and population groups will become increasingly visible in this phase. Also, as lockdown-easing advances, we will be able to appreciate to what extent, despite the various economic policy actions applied, the crisis is causing more lasting harm to our productive system.

Finally, it cannot be ruled out that the pandemic may cause some structural changes to the economy, although these are difficult to define at present. For instance, this crisis has already highlighted certain vulnerabilities associated, for example, with the global fragmentation of production, which had gone relatively unnoticed in recent years. It has also prompted notable changes in the behaviour of economic agents, and in the way and intensity with which new communication technologies are being applied in different areas. Promptly identifying these structural changes and understanding their implications for the economy as a whole, and for specific sectors, firms and population segments, is crucial.

This second phase of economic recovery is marked by high uncertainty, continuing restrictions and health safety measures, and the presence of potential harm and structural changes to the economy. In this phase, the economic policy response must combine two objectives: to support the recovery (which advises not withdrawing the support measures prematurely, as that would increase the risk of economic growth enduring more lasting harm); and to help the economy adjust to the post-pandemic scenario.

To this end, the composition and duration of the policies supporting the economy should be attuned to the health situation and economic circumstances. In particular, the measures set in train in recent months, along with other new measures that will be needed, should be adapted to the pace at which economic activity regains some normality. This pace, as I said, will foreseeably be very uneven across productive sectors and firms.

In parallel, the early identification and understanding of crisis-induced harm and structural changes is crucial. Successfully tackling such changes will call for the economic policy response not to be directed solely at temporarily sustaining the income of the firms and workers affected. The response must also help the productive system adapt to the new reality and smooth the efficient reallocation of resources across sectors and firms.

In this phase, in the monetary and financial realms, to whose euro area-level decisions the Banco de España contributes along with the European Central Bank (ECB) and the Single Supervisory Mechanism (SSM), the priority remains clear: to continue supporting the economic recovery. In this connection, beyond the decisions already adopted in recent months, on the ECB Governing Council we have reiterated our commitment to do everything it takes to support euro area citizens and firms in these extremely difficult times. This includes ensuring that our monetary policy is transmitted to all sectors of the economy and to all jurisdictions, and heading off financial fragmentation problems such as those experienced in the past. Accordingly, the Governing Council continues to stand ready to adjust all its tools as necessary. Further, in the supervisory arena, we must continue to closely monitor banks and financial markets so that they continue to provide the necessary flow of credit to the economy. We must also scrutinise the risks to financial stability arising as a result of this crisis, and be prepared to offer an appropriate European response should they materialise. As indicated in my May testimony, I believe we should all share the objective of preventing the current crisis from ultimately paving the way for an across-the-board tightening of financing conditions or from seriously damaging our financial system.

Domestically, and with the foregoing twin aims of attending to the most pressing short-term needs and promoting the economy's adaptation to the post-pandemic scenario, in the second phase of the crisis some of the measures already applied in recent months should be temporarily extended. In particular, it would be desirable that, in some of the sectors or firms most affected by this crisis, favourable short-time work scheme conditions should remain in place. In parallel, the proper functioning of the various internal flexibility mechanisms available to firms under the current labour market framework should be ensured, all the more so in a situation, such as that described, which is changing and shrouded in great uncertainty. The measures deployed in support of certain groups which, in all certainty, are going to remain vulnerable, should also be extended in a targeted fashion for some time. Likewise, in the case of the public liquidity-support lines for firms, it would be advisable to assess the possibility of extending the current mechanisms by means of instruments that prioritise access to financing for those agents with sounder viability prospects.

Secondly, new measures in various areas should be added. There are several cases in point: improving active labour market and training policies for the unemployed and temporarily suspended workers, to maintain their employability and smooth their reallocation in the labour market; the review of business restructuring and insolvency processes, making them swifter and more effective so that businesses in financial difficulty – whose number will foreseeably increase in the coming months – may have access to a preventive restructuring framework enabling them to continue in business while they are still viable; and strengthening the education system to ensure that students acquire the necessary qualifications even in the absence of presence-based teaching.

Thirdly, thought should be given to adding a fiscal impulse in the early stages of the recovery, which may prove particularly necessary against a background of high uncertainty, and directing recovery efforts in our productive system. Here it would be recommendable to prioritise, in the short term, public investment in innovation, in technological capital, in education and lifelong learning, and in projects that contribute to the transition to a more sustainable economy. That would align to the strategic guidelines recently laid down by the European authorities. The use of financing from the recovery fund proposed by the European Commission, which is still pending approval, should also prioritise these areas.

Fourth, the extraordinarily complex macroeconomic scenario which this pandemic is shaping makes it all the more necessary to define an ambitious structural reform agenda geared to increasing the economy's potential growth. Such reforms were already necessary pre-crisis, given our economy's poor productivity dynamics, the high structural unemployment rate and temporary employment ratio, and the challenges associated with population ageing, rising inequality and climate change. We should add to these challenges those that are emerging as a result of this crisis. Included here are the potential roll-back of globalisation and the accelerating digitalisation of the economy, and others which already required an international response before this crisis, namely the need to complete economic and monetary union and to promote multilateralism at the European and global levels.

Finally, nor should we forget that the shock therapy applied in the early stages of the crisis is, while necessary, not free from adverse secondary effects. And these are particularly visible in the increase in public debt which will come about owing to the downturn in activity and to the economic policy response.

Thus, just as a resolute fiscal response in the short term will help lessen the future damage to our economy, we must accept that a greater budgetary impulse at present should go hand-in-hand with a clear strategy to restore health to public finances in the medium term through a review of spending and of tax structure and capacity. This is particularly necessary in countries, like Spain, that are facing this crisis from a starting position marked by high levels of public debt and a structural deficit.

The short-, medium- and long-term economic challenges Spanish society faces are considerable. I shall therefore set out the reasons which, in my view, warrant the urgent launch of an ambitious, early, comprehensive, permanent and assessable strategy of structural reforms and fiscal consolidation, whose main details I shall address later.

The strategy must first be ambitious. The scale of the challenges the Spanish economy faces demands ambition, if we truly aspire to lay the foundations for sustainable and balanced growth.

Second, regarding the most suitable time for this strategy, we must distinguish between its design and its implementation. Consolidation must be applied once the current recessionary episode and the adverse economic effects of the pandemic are behind us. But there should be no delay in its design and communication. A prompt definition of this strategy would significantly benefit the credibility of our economic policy, leading to its subsequent gradual application and the boosting of the expansionary effects of the current fiscal measures.

In the case of the structural reforms, their design and implementation should be expedited. This is because their positive effects take time to become visible and the expectations as to their application may strengthen agents' trust in the future growth capacity of our economy. This latter aspect is key. Enhanced expectations about the future normally entail positive effects on agents' spending and investment decisions, even in the very short term.

Third, the strategy should be comprehensive, given that most of our economy's challenges are closely interconnected. Only an overall strategy explicitly acknowledging the numerous interconnecting channels of the various challenges facing the Spanish economy can offer a suitable response. By way of example, the structural reforms enacted to increase our economy's growth potential and to address the structural mismatches in the Spanish labour market will in all certainty bear on public finances and inequality levels considerably. Likewise, population ageing problems cannot be resolved without taking into account the public sector budgetary constraint or the inequality dynamics involving individuals and generations. The comprehensive nature of the strategy will naturally entail international (and, in particular, European) actions which, against such an integrated and globalised background as at present, are vital for the future of the Spanish economy. Our ambition must be such as to decisively influence these actions.

Fourth, the strategy should be pursued with a view to it lasting. Generally, uncertainty over the durability of the legal framework in which economic activity unfolds adversely influences household and business spending and investment decisions. But these negative effects of uncertainty on the legal framework are particularly high in a context of economic crisis like the present. Hence, it is essential that the economic policy strategy be designed so that a high degree of consensus in all domains (political, social and economic alike) presides over the recovery from this crisis, ensuring the durability of the strategy over time (a pre-requisite if it is to be credible and, therefore, effective). In my previous testimony before Parliament in May, I mentioned the need for a political agreement spanning several legislatures. Today, I reiterate this need.

Finally, any strategy conceived with a medium-term horizon has to be carefully assessed. Broadly speaking, any economic policy measure should call for a detailed evaluation of its advantages and disadvantages, both before and after its implementation, by means of regular assessments that enable areas for improvement in its design or in its application to be identified. Adopting this culture of assessment in economic policy design should, in fact, be one of its pillars. To achieve this objective, the authorities must have sufficiently detailed data, either from an administrative source or from ad hoc surveys. And this information should also lend itself to analysis by the research community.

In the rest of my address to you, I shall offer a brief outline of the disruption the pandemic has already caused to economic activity and of the projections on the Spanish economy for the short and medium term. Later, in what will be the core of my address today, I shall detail the main challenges the Spanish economy must face in the coming years. There, I will outline the key aspects which, in the opinion of the Banco de España, should underpin the economic policy response to each of these challenges.

2. The economic crisis caused by the coronavirus pandemic

The impact of the COVID-19 pandemic, in Spain and internationally, has been extraordinarily acute. From a healthcare perspective, it has caused the loss of thousands of lives and has brought the healthcare systems of most of the countries affected to the brink of collapse. From an economic standpoint, mainly as a result of the lockdown and social distancing measures that had to be adopted to contain the spread of the pandemic, the contraction of economic activity has been largely unprecedented.

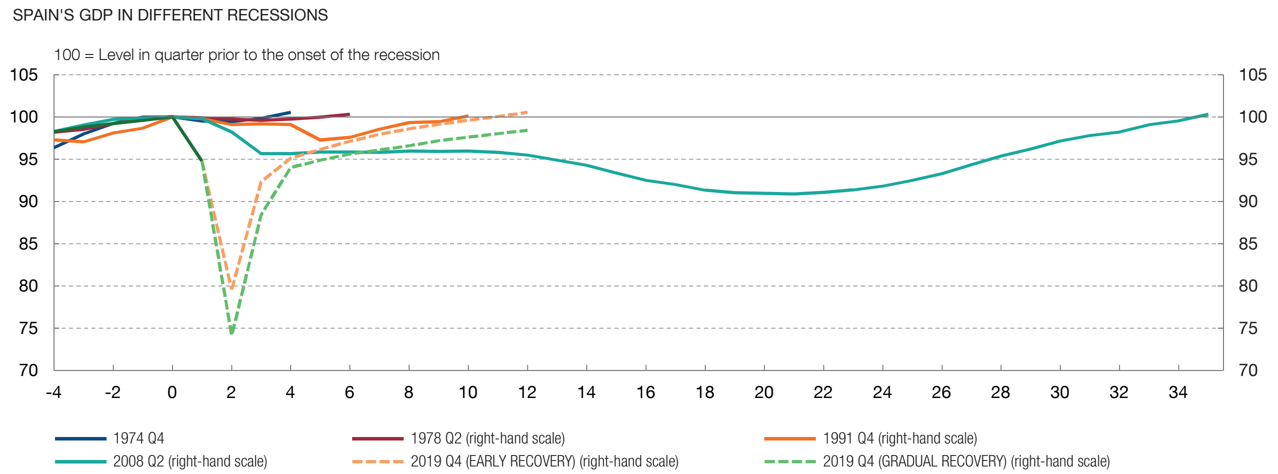
For instance, China, the first economy to be hit by the disease, saw in Q1 the biggest decline in its GDP, quarter-on-quarter, in history (close to 10%). In the United States, GDP declined, in annualised quarter-on-quarter terms, by 5% in the same period. Job destruction was particularly marked, with an increase in the unemployment rate to record highs so far this year since the outbreak of the pandemic.

The Spanish economy was likewise affected by these dynamics. Indeed, it is one of the hardest-hit by this crisis to date. Specifically, on preliminary estimates by the National Statistics Institute (INE), Spain's GDP slumped by 5.2% in Q1, the biggest quarter-on-quarter decline in our recent history, also exceeding the euro area average (3.6%).

And this despite the fact that the lockdown measures only affected the last fortnight of Q1. The fact that virtually all of the restrictions linked to the state of alert have been in force for more than half of Q2 will necessarily mean a significantly sharper decline in activity in this period than that recorded in Q1. On Banco de España estimates, this contraction in GDP might stand at between 16% and 21.8% in quarter-on-quarter terms.[2]

Chart 1

THE SPANISH ECONOMY'S GDP UNDERWENT AN UNPRECEDENTED CONTRACTION IN 2020 H1



SOURCES: INE and Banco de España.

2 See Banco de España (2020), "Quarterly Report on the Spanish Economy", *Economic Bulletin*, 2/2020, Banco de España.

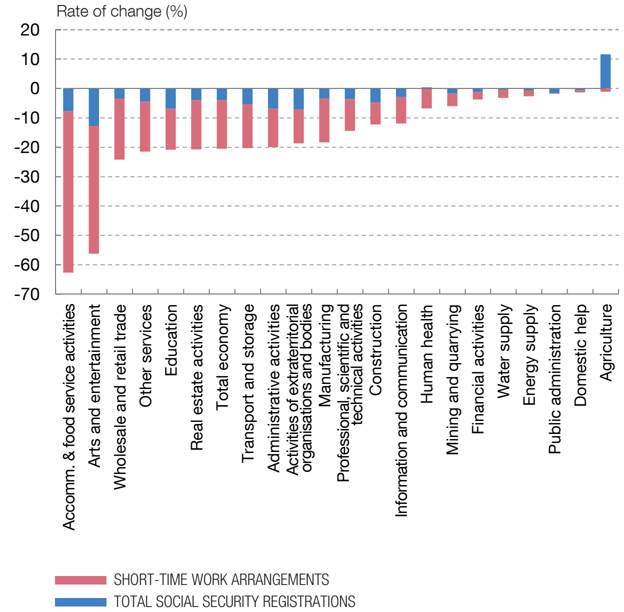
Without seeking to be exhaustive, I wish to mention two areas where the extraordinarily severe impact of this crisis on our economy can clearly be seen. First, according to Social Security registrations data, around 675,000 jobs (3.5% of the total) were destroyed from when the state of alert was declared until end-May. Despite their size, these figures would only be offering a partial view of the impact of the crisis on employment, since they do not include furloughed workers (subject to temporary layoffs or short-time work arrangements, ERTEs by their Spanish initials) or the self-employed who have temporarily ceased their activity. The bulk of the labour market correction in Spain in recent months has precisely been through these two temporary employment adjustment instruments – the ERTEs and discontinuation of activity for the self-employed – promoted by the Government in its economic policy response to the crisis. In fact, if these workers and the self-employed subject to these schemes are taken into consideration, the adjustment in the Spanish labour market from mid-March to end-May would affect more than 26% of total employment.

Further, since the onset of the crisis, the number of firms registered in Social Security records has undergone the biggest fall in its history. Specifically, between mid-February and end-May, this number fell by nearly 108,000. This entails a year-on-year decline of 9.2% in May, much larger than the maximum contraction recorded following the eruption of the global financial crisis (7.2% in April 2009). Among other things, this indicator evidences the severity of the impact of this crisis on Spain's business sector, too, the adjustment of which will obviously be closely related to that observed in the labour market.

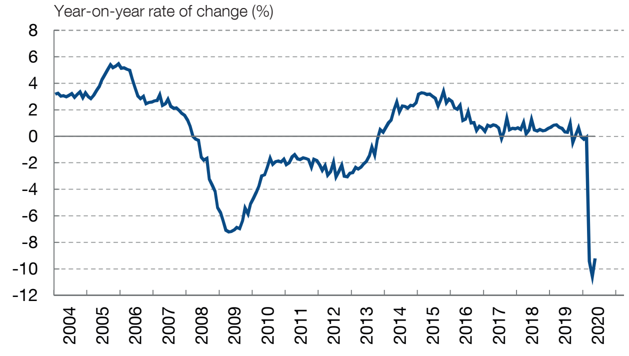
Chart 2

THE CRISIS IS HAVING A VERY SEVERE IMPACT ON EMPLOYMENT AND THE NUMBER OF FIRMS REGISTERED FOR SOCIAL SECURITY PURPOSES

1 TOTAL SOCIAL SECURITY REGISTRATIONS AND IMPACT OF SHORT-TIME WORK ARRANGEMENTS BY SECTOR OF ACTIVITY BETWEEN FEBRUARY AND MAY



2 FIRMS REGISTERED FOR SOCIAL SECURITY PURPOSES



SOURCES: Ministerio de Inclusión, Seguridad Social y Migraciones, and Banco de España.

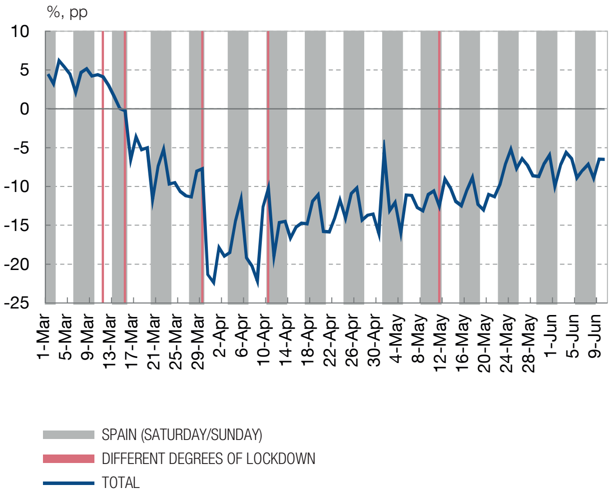
It is true, however, that economic activity has begun to regain momentum as the plan to gradually ease the restrictions initially imposed on mobility and activity in certain sectors has moved forward. Should this momentum continue, it would open the way for a more favourable performance of activity in the second half of the year. Yet this recovery would be insufficient, for the moment, to compensate for the sharp falls recorded since mid-March and it would still be subject to considerable uncertainty.

Firstly, there is much uncertainty as to how the disease will evolve and the possibility of new outbreaks arising in the coming months cannot be ruled out, not in any event until a vaccine or effective treatment for COVID-19 is widely available.

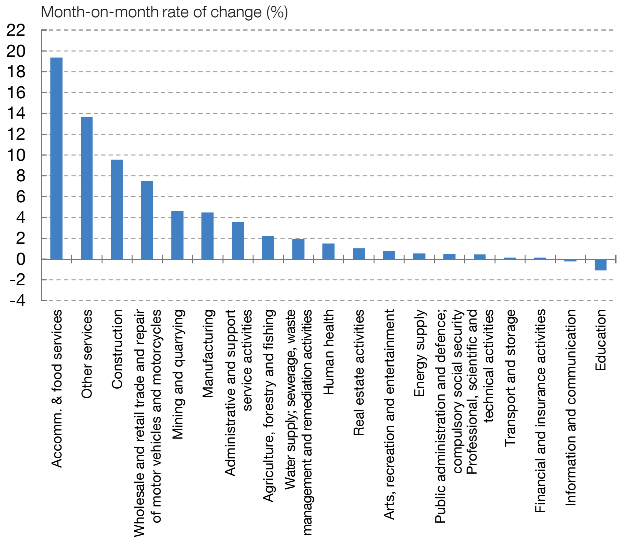
Chart 3

ACTIVITY STARTED TO REGAIN MOMENTUM IN RECENT WEEKS AS THE LOCKDOWN WAS EASED

1 ESTIMATED IMPACT OF DIFFERENT LOCKDOWN MEASURES ON ELECTRICITY CONSUMPTION



2 EFFECTIVE SOCIAL SECURITY REGISTRATIONS IN MAY BY SECTOR OF ACTIVITY
Total workers registered less those subject to short-time work arrangements



SOURCES: Red Eléctrica de España, European Commission, INE and Banco de España.

Secondly, it is also difficult to calculate, at this time, the structural damage this crisis might inflict on the business sector and the Spanish labour market and, consequently, on the growth potential of the economy as a whole in the medium term.

Reflecting this highly uncertain environment, the latest Banco de España projections,[3] which were published on 8 June and are part of the Eurosystem's projections for the euro area as a whole, consider several scenarios based on different assumptions regarding the pace at which a certain level of normality can be recovered from both a health

3 See *Macroeconomic projections for the Spanish economy (2020-2022): the Banco de España's contribution to the Eurosystem's June 2020 joint forecasting exercise*.

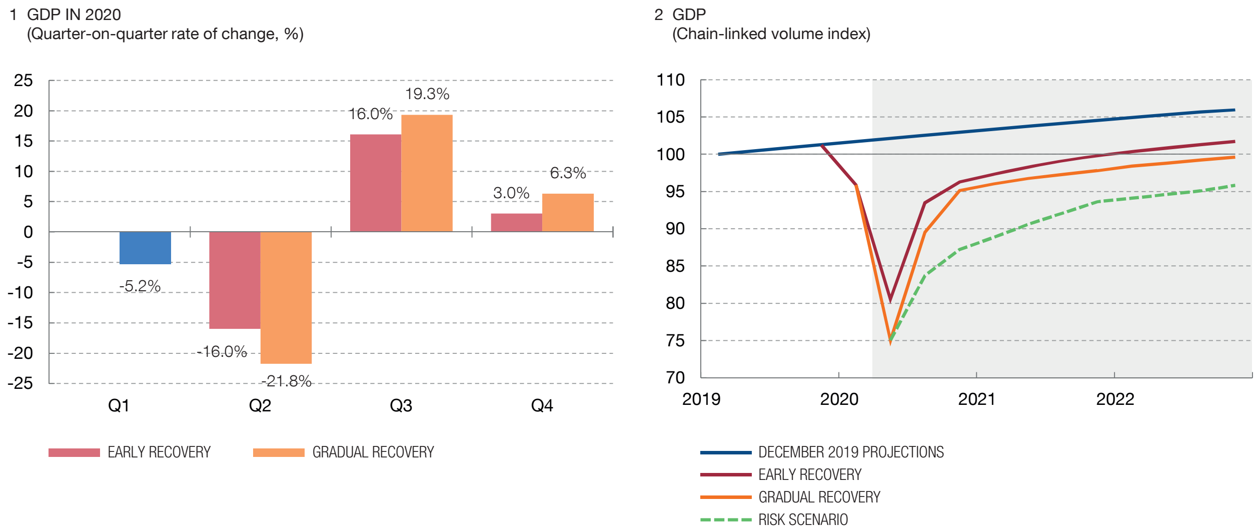
and an economic standpoint. For the purpose of this appearance, I would like to highlight three key aspects of these projections.

First, under all the scenarios there will be very sharp falls in Spanish GDP in 2020. The first “early recovery” scenario depicts a situation of fast-paced recovery as from the second half of Q2 in which no significant health-related, economic or financial obstacles would emerge in the coming quarters. Under this scenario, although it is expected that GDP might increase by 16% in Q3 (the highest quarter-on-quarter growth in our history), output would fall by 9% in all of 2020.

The second “gradual recovery” scenario incorporates a more persistent impact of the sharp decline in activity during the strict lockdown phase and includes the possibility of fresh outbreaks of the disease until a vaccine or effective anti-viral treatment becomes available. Against this background, agents’ economic performance would be affected and it might be necessary to reintroduce temporarily certain social distancing measures. This would slow down the economic recovery relative to the foregoing scenario and, although GDP would grow at very strong quarter-on-quarter rates in the second half of the year (over 19% and 6% in Q3 and Q4, respectively), the fall in output this year would be 11.6%.

Chart 4

THE BANCO DE ESPAÑA'S LATEST PROJECTIONS FORESEE A VERY STEEP DECLINE IN GDP IN 2020, WITH A GRADUAL RECOVERY IN 2021-2022



SOURCES: Banco de España and INE.

The economic recovery would only allow a return to activity close to its pre-crisis levels at end-2022. Specifically, at the end of the projection period, GDP would be about 0.5 percentage points (pp) up on its pre-crisis level under the early recovery scenario, while it would still be 1.6 pp lower under the gradual recovery scenario. Nonetheless, relative to the level projected in December 2019, these gaps would stand almost at 4 pp and 6 pp, respectively. Therefore, we are talking about a highly adverse shock in the short term whose effects will continue over a long horizon.

Also, we cannot rule out other scenarios in which the recovery might face significant obstacles further slowing the exit from this crisis. The nature of these obstacles is, a priori, diverse, and there is a possibility that the disease will unfold more adversely, that the discovery or widespread use of a vaccine for COVID-19 will be significantly delayed, or that greater harm will be inflicted on the productive system and the financial position of the economic agents than that considered under the foregoing scenarios. Any of these factors could significantly condition the exit from the current period of recession, resulting in a weaker recovery. To try to illustrate an adverse situation of this kind, the Eurosystem's exercise, of which the Banco de España's projections I refer to are part, includes a third scenario which tries to implicitly incorporate the possibility of some of these risk factors emerging in the coming months. For the Spanish economy, this could entail a GDP drop this year of around 15%. As you may imagine, the level of uncertainty when drawing up a risk scenario of this kind is extraordinarily high. However, in any event, the foregoing figure is a serious warning as to the magnitude of the difficulties our economy (and that of other European countries) is facing to resume normally functioning economic activity in the wake of the brutal shock we have endured over the past few months.

Second, the projections described are, in general, somewhat more negative in the short term than those considered for the euro area as a whole. The latest forecasts by other international organisations, such as the European Commission and the OECD, were already pointing in this direction. Several factors contribute to explaining the greater relative impact of the crisis on the Spanish economy. One of these is Spain's productive structure, with a very high weight of the sectors most affected by this crisis, such as tourism and activities involving a high component of social interaction. Another is the high percentage of temporary unemployment in our labour markets and a business demography in which SMEs predominate more than in other countries. These two aspects make us relatively more vulnerable to shocks like the current one.

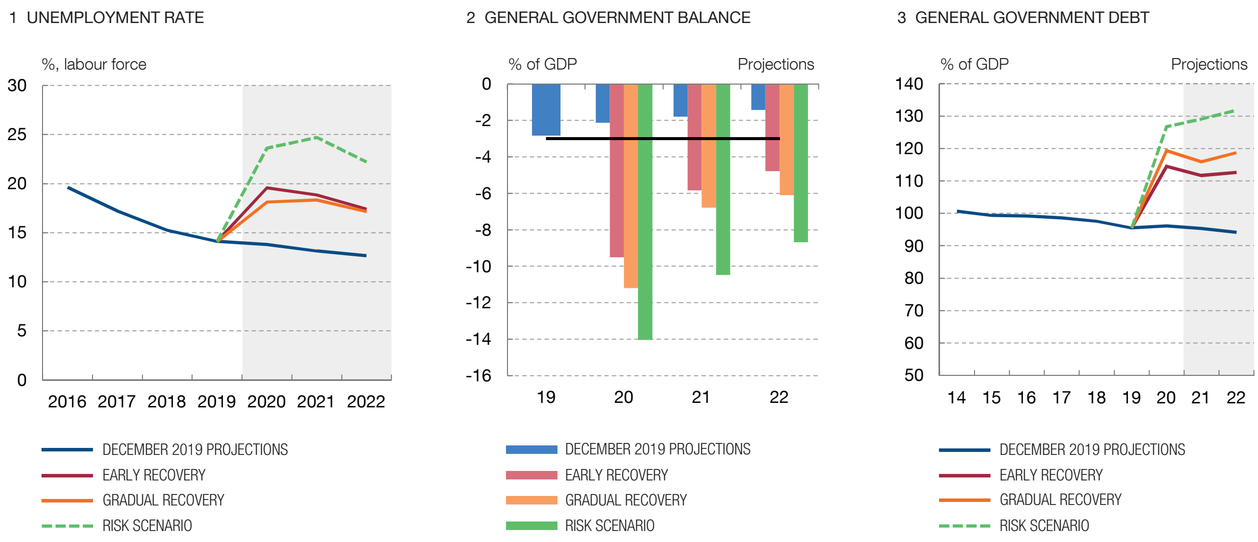
Lastly, beyond the impact of the crisis on GDP, these projections also point to a very substantial and persistent increase in the unemployment rate, public debt and the budget deficit.

Specifically, the unemployment rate would increase significantly this year: up to 18.1% and 19.6% of the labour force under the early and the gradual recovery scenarios, respectively, still remaining above 17% in 2022.

The general government deficit, which was 2.8% of GDP in 2019, would rise this year to 9.5% under the early recovery scenario and to 11.2% under the gradual recovery scenario. The rebound in economic activity in 2021 and 2022, together with the waning impact of the transitional measures adopted in response to the pandemic, would give rise to

Chart 5

THIS CRISIS WILL RESULT IN A SEVERE AND PROTRACTED WORSENING OF THE UNEMPLOYMENT RATE AND PUBLIC FINANCES



SOURCE: *Macroeconomic projections for the Spanish economy (2020-2022),* Banco de España.

a decline in the deficit in those years, but it would still stand in 2022 at substantially higher levels than in the past two years. Likewise, the public debt/GDP ratio would increase by between 20 pp and 25 pp, approximately, in 2020, to stand at close to 115% and 120% in each of the two scenarios, remaining at very high levels in the following two years.

In our opinion, the key magnitudes of these forecasts, together with the structural challenges facing the Spanish economy, already present before this crisis, evidence the need to urgently deploy an ambitious global growth strategy. This would be over a medium-term horizon and would involve the design of a fiscal consolidation programme to be applied as the most adverse effects of the crisis are overcome and the recovery path takes hold.

3. Improving productivity dynamics

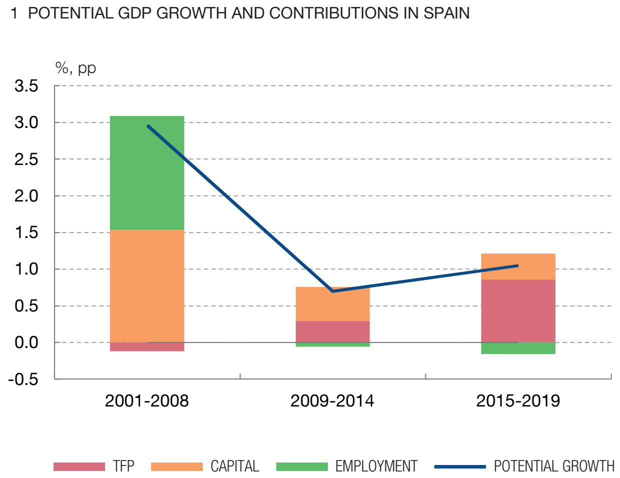
Allow me now to move to a detailed description of the main challenges the Spanish economy must tackle in the medium term to increase our potential growth capacity.

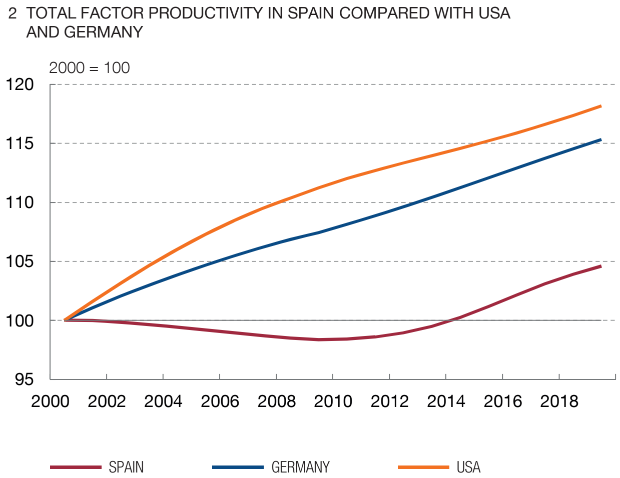
Before the coronavirus crisis broke, Banco de España estimates placed the Spanish economy's growth potential at slightly over 1% per annum. As mentioned, it is still too soon to accurately assess the scale of the harm the current crisis will cause to this potential growth. But the impact will unquestionably be negative and, therefore, our growth capacity looking ahead could be lower than that estimated pre-crisis.

The main factor behind this modest potential growth of the Spanish economy is undoubtedly our low productivity growth (measured by total factor productivity (TFP)). This aspect is not in any terms novel or the outcome of some passing phenomenon. It is structural in nature. Over the past 20 years TFP has grown in Spain at an approximate annual average rate of 0.2%, far below the related growth in Germany (0.8%, on the European Commission's estimates) and in the United States (0.9%).

Chart 6

THE SPANISH ECONOMY HAS MODEST GROWTH POTENTIAL, WEIGHED DOWN BY LOW PRODUCTIVITY GROWTH





SOURCES: Banco de España and European Commission.

The recovery phase prior to this crisis illustrates this problem. The rise in Spanish per capita income was the outcome of the increase in numbers employed, while the contribution of apparent labour productivity gains was very small. And, similarly, the gains in competitiveness in this period (measured through unit labour costs relative to those in the euro area as a whole) were above all obtained by the adjustment of labour costs, while true productivity gains were more modest. In short, according to the European Commission, TFP grew by 0.4% in Spain in annual average terms, from 2013 to 2019, compared with 0.5% in the euro area. Consequently, the unfavourable gap with the other member countries in terms of TFP continued to widen, albeit at a lesser rate, as it has since the creation of the euro.

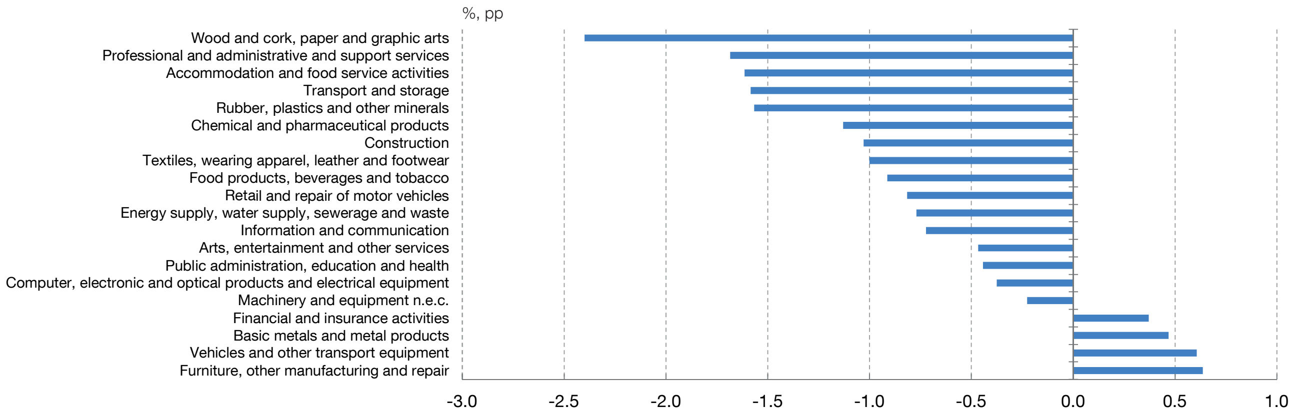
These differences should in no circumstances be underestimated. Productivity gains are a basic ingredient for successfully achieving a sustainable increase in a country's economic well-being. Indeed, the bigger these gains are, the greater the possibilities of increasing wage levels and the quality of jobs created, as well as the funds for financing public policies.

Moreover, the sectoral composition of the Spanish economy explains only part of these lacklustre productivity dynamics. In fact, while our productive structure is admittedly skewed towards sectors of activity that usually show low productivity growth, lower productivity relative to other European countries can be seen in practically all sectors.[4] The average productivity of Spanish firms stands some 10%-40% lower than their European peers, depending on the sector, with such differences particularly notable in the case of services companies.

Chart 7

SPAIN'S PRODUCTIVITY COMPARED WITH OTHER COUNTRIES IS LOWER IN PRACTICALLY ALL ECONOMIC SECTORS

ANNUAL GROWTH DIFFERENTIAL IN TOTAL FACTOR PRODUCTIVITY (TFP) BETWEEN SPAIN AND THE EU-12 (2000-2016)



SOURCE: EUKLEMS.

True, this crisis is affecting certain segments of activity more acutely. But, regardless, any reconstruction strategy that adopts a medium-term perspective needs to tackle the very different structural aspects which, across the board, are restricting productivity gains in most sectors and, therefore, the growth potential of the economy as a whole.

Among these constraints on productivity gains, I shall focus today on three particularly significant areas where the Spanish economy is in a relatively unfavourable

4 See P. Cuadrado et al. (2020), *A sectoral anatomy of the Spanish productivity puzzle,* Occasional Paper No 2006, Banco de España.

position compared with our European partners: business dynamism and the degree of sectoral competition; human capital; and technological capital.

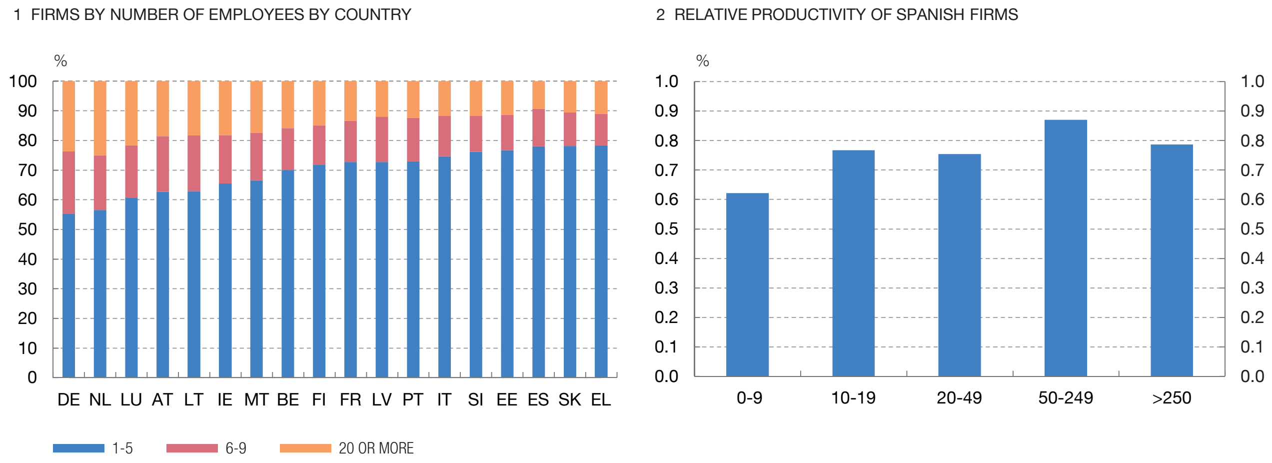
Promoting business dynamism and growth, and raising the degree of sectoral competition

The economic literature stresses that market structure and the business environment play a fundamental role in the proper functioning of goods and services markets. They are also a key determinant of the economy's efficiency and productivity.[5] In turn, these aspects are influenced by regulations. Thus, the empirical evidence available suggests that stricter regulations tend to be associated with lower business dynamism and investment, and with lower productivity.

In relation to this matter, the Spanish economy is firstly characterised by the small size of its firms, which is a key factor for explaining our low aggregate productivity. In 2019, the percentage of firms with fewer than five employees was 78% in Spain, far higher than the euro area average of 69%. And it is precisely in Spanish SMEs that we see a high, negative productivity gap with their European counterparts.[6]

Chart 8

SMALL FIRMS, WHICH ARE LESS PRODUCTIVE, PREDOMINATE IN SPAIN'S BUSINESS DEMOGRAPHY MORE THAN IN OTHER COUNTRIES



SOURCES: Central Companies Directory and Central Balance Sheet Data Office of the Banco de España.

Boosting the growth of small-sized firms would not only be conducive to productivity growth, but would also have substantial implications in terms of the financial soundness of the business sector as a whole. It is widely acknowledged that the economies with a high weight of small-sized firms usually evidence a greater degree of financial vulnerability. For one thing, small

5 See Banco de España (2016), Chapter 4, *Annual Report 2015*.

6 See Banco de España (2016), Chapter 4, *Annual Report 2015*.

firms, being less diversified, both geographically and in terms of products, are more vulnerable to macrofinancial shocks. For another, these companies usually have greater difficulty gaining access to external financing, owing both to investment in them being usually perceived as riskier, and also because of problems of asymmetric information (between investors or lenders and the firm itself) and of limited scale.[7] Moreover, the size of firms is an obstacle to gaining access to financing on the wholesale markets via debt issuance. This means that, generally, small companies have a less diversified financing structure than their larger competitors. And frequently, such financing is particularly dependent on bank loans, making them more vulnerable to shocks affecting banks (as became manifest during the previous financial crisis).

Looking ahead, everything suggests we must delve into the various reasons why the Spanish business sector is so skewed towards small firms, and to have mechanisms at hand to promote business growth. At the State level, there is a broad set of regulations contingent upon corporate size which may deter business growth.[8] In particular, some regulations increase the corporate burden once companies have more than 50 employees (along with other activity-based criteria).[9] Plausibly, therefore, some companies opt to remain small to avoid the greater costs that exceeding this type of threshold entails. The empirical evidence is along these lines, confirming the presence of an abnormally high number of firms just below this regulatory threshold.[10]

Further, the legislation on public contracts requires firms to accredit a degree of solvency which is usually related to its turnover or net worth and to the works executed in recent years. Accordingly, recent start-ups have greater difficulty successfully bidding for contracts, irrespective of their productivity. Similarly, there are distortions in other areas, relating to finance or energy costs.[11] In this respect, we must ensure that the objectives of these types of regulations, which introduce a degree of business discrimination, are compatible with competition between established firms and recent start-ups, and do not pose added difficulties to business growth possibilities.

On the role of regulation, this is habitually one of the main obstacles to investment mentioned by respondent firms in surveys.[12] In this connection, despite the significant

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7 Indeed, the economic literature has identified the greater asymmetric information of small-sized firms linked to the lesser quality and quantity of information available on their economic and financial situation as one of the sources of their greater problems in gaining access to external financing. Moreover, their small size means that the fixed costs that lenders incur in analysing their economic and financial situation are comparatively high.

8 See the evidence on the impact of specific regulatory thresholds on the breakdown by size of firms in Chapter 3 of the Banco de España *Annual Report 2014,* and in European Commission (2016), *Report on Spain 2016*.

9 For example, exceeding this threshold entails the need to set up a workers' committee, make VAT payments monthly, forgo the possibility of presenting abridged financial statements and to engage auditors.

10 See L. Garicano, C. Lelarge and J. van Reenen (2016), "Firm Size Distortions and the Productivity Distribution: Evidence from France", *American Economic Review,* 106, pp. 3439-3479. For evidence on the corporate income tax reporting threshold in Spain, see M. Almunia and D. López-Rodríguez (2018), "Under the Radar: The Effects of Monitoring Firms on Tax Compliance", *American Economic Journal: Economic Policy,* 10, 1-38.

11 For example, in the financial realm, firms of different sizes can adopt different corporate models, which affect access to financing and liability according to the share capital paid in. Also, in the energy field, there are permits to sell self-generated electricity as from a certain plant capacity and the possibility of charging for the right to interrupt supply at large corporations.

12 See, for instance, the European Investment Bank's 2017 survey.

improvements in the past decade, the Spanish regulatory framework continues to show room for improvement when compared with that of the best-practices economies, according to the World Bank's *Doing Business report.*[13] This report shows that the administrative burden for business start-ups is, generally, more onerous in Spain. Currently, according to this information, 7 formalities, 12.5 days and 3.9% of annual per capita income are needed to start a business, compared with 4 (5), 4.5 (4) and 0% (0.7%), respectively, in the United Kingdom (France).

In a country as decentralised as Spain (in 2018, 71.8% of regulations were enacted by the regional governments), it would also be advisable for regional and local governments to bring their different practices, sector by sector, onto a common footing to attain regulatory standards in keeping with best practices. And this while retaining the objective of fomenting productivity and not restricting the entry of potential competitors. Currently, there are notable differences in the regional formalities needed, for example, to undertake investment projects. These obstacles to the singleness of the market might be curtailing not only business start-ups, but also their subsequent development capacity. The indicators available further show that the room for improvement in the regulatory arena would be particularly extensive in some sectors, such as the retail trade and certain transport and professional services segments.[14]

In the specific case of the regulations governing insolvency procedures, Spain has, despite partial reforms approved in recent years, a more inefficient system than that of our European peers.[15] It would thus be worth considering the proper transposition of the regulations in the European directive on restructuring and insolvency.[16] This would provide for rapid and simplified administrative procedures that would grant debtors in financial difficulties access to a preventive restructuring framework enabling them to continue to pursue their business activity while it is still viable. It would thus enhance the efficiency of the restructuring and insolvency procedures and ease the financial burden. This reform is especially important in the present circumstances, in which there will foreseeably be an increase in personal and business insolvency procedures in the wake of the large-scale shock we are experiencing. Speed of resolution is paramount in these procedures so as to minimise the losses in asset value that would materialise if they were to drag on. And all the more so in a situation in which the economic policy response in the short term makes it very likely that the liabilities of ailing businesses to general government will be much higher than in previous crisis periods. The introduction of more appropriate procedures and incentives would also avoid excessively high levels of business liquidations and destruction of the productive system that would weaken long-term economic growth and recovery potential.

Regulatory enforcement also has room for improvement in Spain. For example, according to various statistical information sources, the Spanish legal system's efficiency is

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13 In Doing Business 2020, Spain is ranked 30th in terms of ease of doing business; 10 European countries stand ahead of Spain. Moreover, Spain is ranked 97th in terms of ease of starting a business.

14 See Indicators of Product Market Regulation.

15 See M. García-Posada and R. Vegas (2018), "Bankruptcy reforms in the midst of the Great Recession: The Spanish experience", *International Review of Law and Economics,* 55, pp. 71-95.

16 Directive (EU) 2019/1023 of the European Parliament and of the Council of 20 June 2019.

below that of other comparable countries, while our rate of litigation is higher. That highlights the need to identify the factors behind these developments and redress them.[17]

All these factors, as part of the institutional framework, are significant when explaining cross-country productivity differences.[18] In this respect, the quantitative indicators that assess the quality of the legal and administrative framework in which the public and private sectors interact confirm that Spain does indeed have extensive room for improvement in this area.[19]

Improving human capital

Another crucial factor for understanding Spanish firms' low productivity relates to the level and quality of human capital.[20] In recent decades, there has been a substantial improvement in the Spanish population's educational level, arising both from the generational shift and from the fact youths have acquired more education in recent years.

However, there remains a significant gap with the European Union (EU) average, affecting the average level of educational attainment of both Spanish workers and employers. Thus, on Eurostat figures for Spain in 2019, 38.9% of the self-employed, 35.9% of employers and 31.1% of dependent employees have a low educational level. These percentages are far higher than those observed in the euro area as a whole (22.2%, 19% and 18.8%, respectively).

This comparative disadvantage can also be seen on considering the adult population as a whole. Spain thus brings up the rear among the OECD countries in the indicators that measure the population's mathematical reasoning ability, and is in penultimate place as regards reading comprehension.

Key challenges for the education system thus persist, such as the high proportion of early leavers from education and training (18.3% among those aged 18-24). This is despite the improvements in this area since the previous crisis, which have lowered the participation rate for Spanish youths aged 16-19 from 30% to 15%. It is also in parallel with an increase in the percentage of the young participating in formal education or in some type of training. As a result, the gap between Spain and other European countries in this area has narrowed. That said, our education system also evidences a negative gap in the indicators of educational quality compared with other developed countries.

17 See J. S. Mora-Sanguinetti (2016), "Evidencia reciente sobre los efectos económicos del funcionamiento de la justicia en España", *Boletín Económico,* enero, Banco de España.

18 See, for example, R. E. Hall and C. I. Jones (1999), "Why do some countries produce so much more output per worker than others?", *The Quarterly Journal of Economics,* 114, pp. 83-116, and E. Helpman (ed.) (2008), *Institutions and economic performance,* Harvard University Press, Cambridge, Massachusetts.

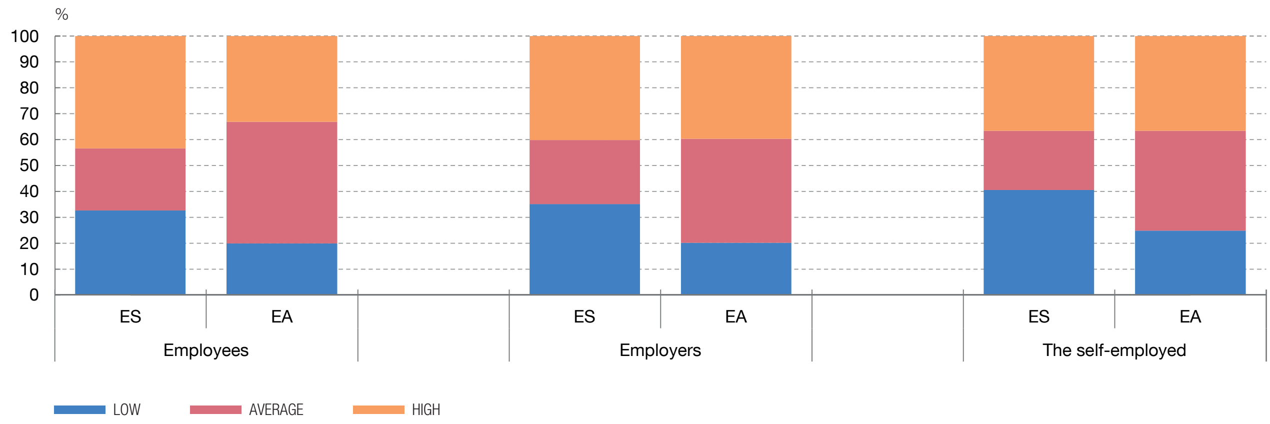
19 For example, the indicator of the quality of public institutions constructed by the World Economic Forum as part of its *Global Competitiveness Report 2019* ranks Spain 13th out of 28 European Union countries. This indicator is partly based on a questionnaire to firms and includes information on ownership rights and their protection, ethical issues and corruption, legal independence, public sector efficiency and security, among other aspects. Similar results for Spain (15th out of 28 countries) are obtained from the World Bank's The Worldwide Governance Indicators.

20 See F. Schivardi and T. Schmitz (2019), "The IT Revolution and Southern Europe's Two Lost Decades", *Journal of the European Economic Association,* forthcoming.

Chart 9

THE EDUCATIONAL LEVEL OF EMPLOYERS, THE SELF-EMPLOYED AND EMPLOYEES IN SPAIN IS BELOW THE EUROPEAN AVERAGE

DISTRIBUTION OF PERSONS IN EMPLOYMENT BY EDUCATIONAL LEVEL



SOURCE: Eurostat (LFS). 2017 data.

These shortcomings, along with the need to address the educational challenges posed by globalisation trends, technological progress and the automation of tasks, point to the advisability of reconsidering the institutional design of the education system, along with curriculum content and the very system of learning. On this point I should like to stress three aspects I consider most important.

First, various OECD papers have advocated reducing curriculum content so as to promote individualised and early guidance for students by teachers. They also suggest focusing teaching on the application of knowledge creatively and not on parrot-fashion learning.[21]

Second, in the university sphere, there is considerable leeway for improving teaching and research staff recruitment, and for tying funding of the system to excellence-based objectives.[22] Here it is worth recalling that in the global ranking of universities, constructed on the basis of variables measuring the quality and quantity of scientific output, Spain has no university among the 100 leading institutions and only seven in the top 400 positions.[23]

Lastly, it would be desirable to draw the design of vocational training closer to that of the leading countries in this area, such as Germany. This is particularly important in a setting in which there is likely to be a future increase in employee skills supply/demand mismatches.

21 See *"OECD Future of Education and Skills 2030"*, https://www.oecd.org/education/2030-project/.

22 See OECD (2019), *Education Policy Outlook: Spain*, OECD Publishing, Paris.

23 See http://www.shanghairanking.com/ARWU2019.html.

I feel I should stress that the implementation of these or other similar initiatives in this area should, as a priority, be underpinned by a more efficient allocation of available resources. This should be based on a diagnosis of present and future labour market needs – with both educational authorities and business leaders necessarily contributing – and of the potential shortcomings and obstacles in the educational arena to meeting these needs.

Finally, in a question closely linked to the current crisis but with significant future implications, it is worth noting that the lockdown and the suspension of face-to-face education in recent months might exert an adverse impact on students' academic performance, particularly those living in low-income households, for whom the possibilities of replacing presence-based education with other alternatives are lower. Thus, with a view to strengthening economic growth in the long term, one immediate economic policy target should be to equip the education system with mechanisms enabling all students to acquire the necessary qualifications, even in the absence of face-to-face education. These measures are particularly pressing given the possibility of fresh virus outbreaks in the future.

Increasing technological capital

Technological capital is another fundamental pillar on which any medium- and long-term growth strategy should rest. There is broad consensus on the positive effect that research, development and innovation (R+D+I) activities have on firms' productivity and people's well-being.[24]

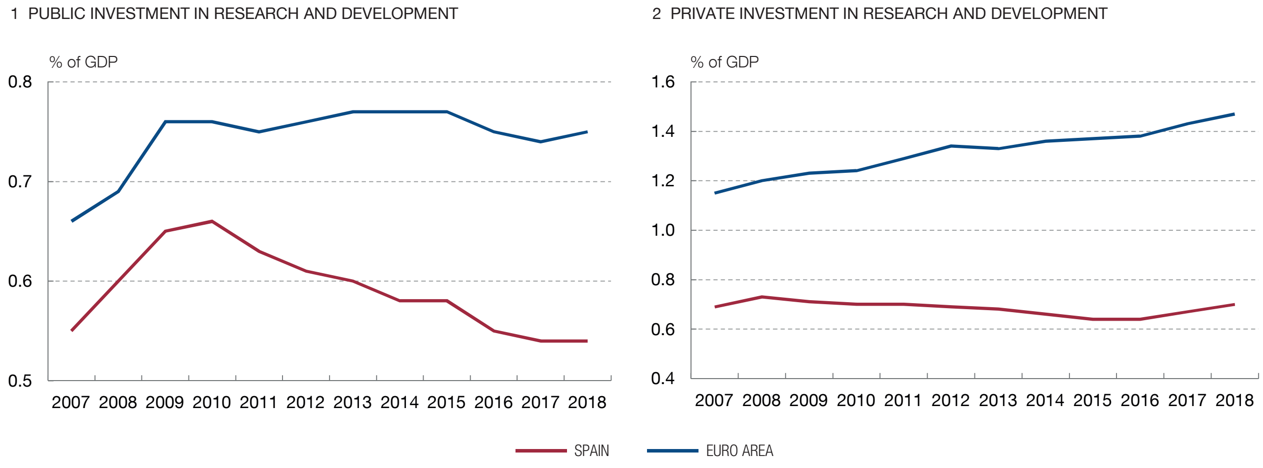
And here, too, Spain falls short when compared with other leading economies. According to Eurostat, the proportion of innovative firms in Spain stood in 2016 at 36.9%, at some distance from the percentages for France, Italy and Germany (57.7%, 53.8% and 63.7%, respectively).[25] Similarly, the weight of investment in R&D activities in Spanish GDP, for the public and private sectors, is 26% and 54%, respectively, below the European average. In particular, the Eurostat data indicate that public investment in research, development and innovation in Spain accounts for 0.5% of GDP, below the euro area average of 0.7%. Spanish private-sector investment in R+D+I stands at 0.7% of GDP, far below the euro area figure of 1.4%. Moreover, the Spanish economy's deficit in terms of investment in R+D+I has worsened in recent years and the technological capital gap in relation to the EU has continued to widen during the recent expansionary cycle.

This technological capital gap between Spain and its European partners is due, at least partly, to certain structural characteristics that restrict firms' innovative capacity in Spain. These include the shortfall in available human capital, to which I have just referred, and the bias in the productive structure towards low-technological-content sectors. But, moreover, one fundamental factor requiring particular attention is access to financing, public and private alike, for business projects with a high innovative content.

24 See, for example, U. Doraszelski and J. Jaumandreu (2013), "R&D and productivity: estimating endogenous productivity", *Review of Economic Studies,* vol. 80, pp. 1338-1383.

25 See *Community Innovation Survey 2016*.

Chart 10
PUBLIC AND PRIVATE INVESTMENT IN INNOVATION IN SPAIN IS ALSO LOWER THAN THAT OF OTHER EUROPEAN COUNTRIES



SOURCE: Eurostat.

The high uncertainty normally surrounding successful investment in R+D+i, and the lengthy time horizon for such success to materialise, warrants general government acting as a catalyst in its financing. This is especially the case in the field of basic research, and all the more so bearing in mind the positive and potentially disruptive effects that certain investments in these areas may have on the population as a whole. Against the current background of economic crisis, this is most relevant since the experience of previous crises indicates that, as occurs with productive public investment, firms' investment in innovation usually drops significantly in times of uncertainty and financial difficulty, with the subsequent adverse repercussions on long-term growth.[26] One of the factors behind this is the comparatively greater difficulties innovative firms face gaining access to bank financing, as they tend to have a lower volume of tangible assets to post as collateral for their loans.

Potential public measures in this area are not confined, however, to setting aside a bigger budgetary item for investment in R+D+i. It would also be worth assessing changes to the arrangements for promoting research and higher-education research studies in order to smooth access for and the personal development of new high-potential researchers. Also worth considering would be a restructuring of the set of public organisations undertaking innovation in Spain. The aim would be to seek to harness to the full potential synergies between them and to strengthen cross-institution resource allocation mechanisms so they may reflect, to a greater extent than at present, academic excellence-based criteria.

26 See P. López-García, J. M. Montero and E. Moral-Benito (2013), "Business Cycles and Investment in Productivity-Enhancing Activities: Evidence from Spanish Firms", *Industry and Innovation,* 20(7), pp. 611-636, and S. Baker, N. Bloom, S. Davis and S. Terry (2020), "COVID-induced economic uncertainty and its consequences", *Voxeu.*

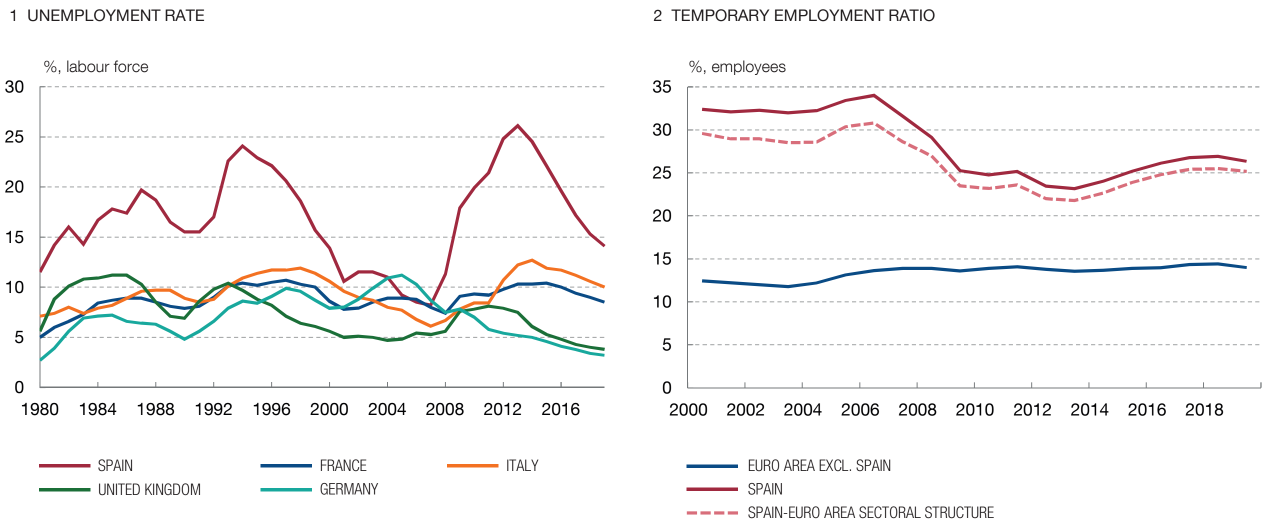
4. Reducing unemployment and job insecurity

I would now like to focus on the challenges the Spanish economy must face regarding the labour market. Considering the central role the labour market plays in any economy, these challenges have significant implications in many other dimensions. Thus, for instance, the regulation and operation of this market clearly influence human capital accumulation by workers and, through this channel, the growth potential of the economy I referred earlier to. At the same time, labour market dynamics directly affect income inequality in society, an issue I will also resume later.

The Spanish labour market has had very pronounced structural shortcomings for decades. These can be more clearly appreciated in crisis periods like the present one. However, it should not be forgotten that they are also, at least in part, the reason why our economy has, for instance, a significantly higher unemployment rate than any of our peers, even in expansionary periods.

Indeed, since 1980, the average unemployment rate in Spain has stood at close to 17%, a figure far higher than in other European countries. Moreover, unemployment in Spain has historically undergone very sharp cyclical changes, with the unemployment rate easily exceeding 20% during crisis episodes. As a result, each recession expulses large groups of workers from the labour market. These include, in particular, those with less work experience, the lesser skilled and, in general, those on temporary contracts and, accordingly, who are less protected.

Chart 11
THE SPANISH LABOUR MARKET'S SHORTCOMINGS LIE BEHIND THE HIGH UNEMPLOYMENT RATE AND TEMPORARY EMPLOYMENT RATIO



SOURCES: Eurostat and Banco de España.

Reducing temporary employment

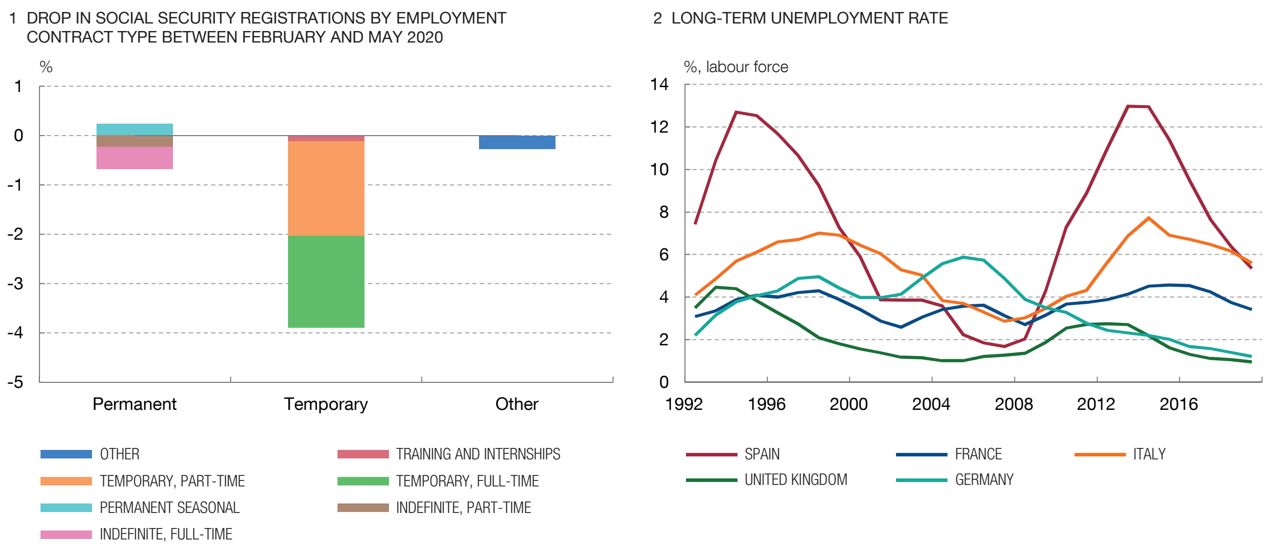
Another differential aspect of the Spanish labour market is its high temporary employment ratio. In the past decade, this ratio has stood at 25.2% relative to total employment, compared with 13.9% in the other euro area countries. Although certain industries in the productive structure of our economy, such as tourism, are highly seasonal, the gap with the rest of the European countries cannot be attributed to seasonality, given that the high temporary employment ratio is across the board in all sectors of activity.

The negative consequences of high temporary employment are diverse. As I mentioned earlier, employees on temporary contracts are precisely those who have disproportionately borne the brunt of job destruction flows in our economy in recent decades.

The same is occurring in the current crisis. According to data on Social Security registrations, from March to end-May this year around three-quarters of the 750,000 jobs destroyed in Spain were temporary. Indeed, the fall in employment was seen to be higher in the provinces where there are more temporary contracts, even after taking into account differences in terms of the sectoral composition of activity.

Chart 12

THE DESTRUCTION OF EMPLOYMENT FALLS EXCESSIVELY ON TEMPORARY EMPLOYMENT; THE LONG-TERM UNEMPLOYMENT RATE IS VERY HIGH



SOURCES: AMECO and Ministerio de Inclusión, Seguridad Social y Migraciones.

We may readily conclude, therefore, that a Spanish labour market adjustment mechanism based largely on the destruction of temporary employment during recessions has the perverse effect of significantly increasing inequality during economic crises.[27]

27 See S. Bonhomme and L. Hospido (2017), "The Cycle of Earnings Inequality: Evidence from Spanish Social Security Data", *Economic Journal,* 127, pp. 1,244-1,278.

Additionally, it has been proven that high temporary employment is associated with persistent effects on workers' subsequent career paths. In particular, when comparing young people of similar characteristics who were able to join the Spanish labour market immediately before and immediately after the liberalisation of temporary hiring in 1984, it is seen that, nearly 30 years later, the latter earn 7% less than the former in terms of employment income. This is so despite the fact that the probability of having a job has increased thanks to this type of contract.[28]

In any event, although the marked temporary nature of the Spanish labour market is most detrimental in times of crisis, it also has adverse effects in expansionary phases. For example, in terms of decisions on investment in human capital by firms and by workers. In this connection, the empirical evidence reveals that temporary workers have fewer possibilities of working in firms that offer training and that, even if they are in firms that do offer it, the likelihood of receiving it is less than that of the permanent employees in the same firm.[29]

Insofar as temporary employment essentially affects the young, whose unemployment rate is very high, this shortcoming in the Spanish labour market influences such important decisions in the life cycle of people as those on the formation of new households. High temporary employment and unemployment have been documented as reducing both the formation of new households and their size, by negatively influencing fertility decisions.[30] The rates at which youths leave the family home to live independently are also seen to be negatively related to the degree of job insecurity,[31] undoubtedly accentuated by the incidence of temporary employment.

For all these reasons, reducing the high duality in our labour market is an unavoidable objective. Employment protection mechanisms should be reviewed under the prism of squaring the necessary protection of workers with flexibility requirements; but it should also be an aim to achieve a fairer division of protection among workers with different contractual conditions. In our opinion, contractual mechanisms that avoid strong discontinuity in the degree of employee protection, in terms of the type of contract they have at each point in time, are an interesting option for tackling this significant dysfunction in our labour market. For this reason, exploring modalities such as contracts with growing firing costs may, in my opinion, be a good starting point for the debate on the design of a new regulatory framework, which should under no circumstances promote a widening of the protection gap already existing between temporary and permanent employees. Also worthy of attention are mixed models. These combine the possibility, while the worker remains in employment, of building up in advance in a fund a

28 See J. I. García-Pérez, I. Marinescu and J. Vall Castelló (2020), "Can Fixed-term Contracts Put Low Skilled Youth on a Better Career Path? Evidence from Spain", *The Economic Journal,* doi:10.1111/ecoj.12621.

29 See C. Albert, C. García-Serrano and V. Hernanz (2005), "Firm-provided training and temporary contracts", *Spanish Economic Review,* 7, pp. 67-88.

30 See Gutiérrez-Doménech (2008), "The impact of the labour market on the timing of marriage and births in Spain", *Journal of Population Economics,* 21, pp. 83-110, and A. Adsera (2006), "An Economic Analysis of the Gap Between Desired and Actual Fertility: The Case of Spain", *Review of Economics of the Household,* vol. 4, pp. 75-95.

31 See S. O. Becker, S. Bentolila, A.Fernandes and A. Ichino (2008), "Youth Emancipation and Perceived Job Insecurity of Parents and Children", *Journal of Population Economics,* 23, pp. 1047-1071.

portion of the related severance costs (the "Austrian backpack" scheme) with a severance payment in the event of dismissal whose amount increases in terms of years of experience.

Improving active labour market policies

We must bear in mind that the unemployment rate was very high in our country prior to the current crisis (13.8% at end-2019), and that almost 43% of the unemployed had been seeking a job for more than one year and around 30% had done so for more than two years. The situation will worsen with the current crisis. Therefore, strengthening the role of policies aiming to enhance the employability of the most vulnerable workers and prevent unemployment from becoming structural is urgently needed.

It should also be noted that the COVID-19 crisis is bearing down very unevenly on different sectors of activity. It cannot be ruled out that some of these dynamics will ultimately prompt permanent changes in the economy's sectoral composition and, therefore, in employment needs in the different productive sectors. In this respect, the sectors that could be most affected by the crisis (including transport, accommodation and food services, leisure and wholesale and retail trade) account for nearly 20% of employment in Spain. These sectors also show a greater concentration of less-skilled workers less used to performing IT, numerical and reading- and writing-related tasks.[32] All of this hampers their employability in other productive sectors that will foreseeably have a better growth outlook in the near future.

For instance, following the 2008 crisis, the limited employability of construction workers in other sectors of activity had a very strong impact on their employment status. Thus, in 2013 more than half of the workers who had been employed in this sector remained unemployed and only 23% had found a job in another sector of activity. In that period, the likelihood of finding a job in a different sector was particularly low for older workers with greater work experience and lower skill levels.

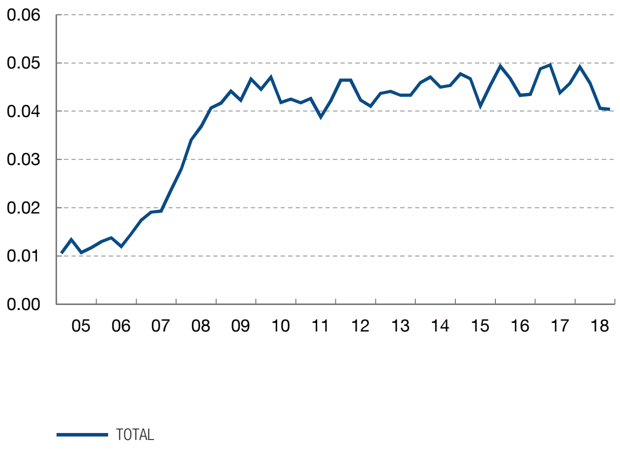
Improving active labour market policies is also necessary over a medium-term horizon. Unquestionably, technological advances (artificial intelligence, automation and robotics) will create new opportunities and will contribute to much-needed productivity growth. However, some workers will lose their jobs in this transition and will not always be in a position to instantly take advantage of the new opportunities.

Active labour market policies and training policies, duly re-designed to boost effectiveness and efficiency, and suitably endowed with funds, are a natural lever for ensuring learning throughout a person's career. They can help workers to acquire new skills, to hone them and to recycle themselves professionally in the face of a changing and, foreseeably, very demanding environment in terms of technological skills. This challenge is even more pressing against a background of rapid population ageing, as I shall later discuss.

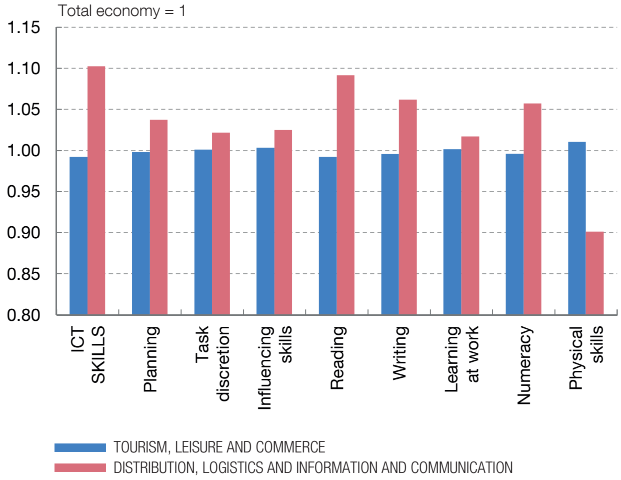
32 See B. Anghel, A. Lacuesta and A. Regil, "Transferability of workers' skills in sectors potentially affected by Covid-19," Analytical Articles, *Economic Bulletin,* 2/2020, Banco de España.

Chart 13
THERE IS A MISMATCH BETWEEN THE SKILLS OF THE UNEMPLOYED AND THOSE REQUIRED BY THE MARKET

1 SKILLS MISMATCH INDEX BETWEEN THE EMPLOYED AND UNEMPLOYED (a)



2 SKILLS MISMATCH BETWEEN VULNERABLE AND BUOYANT SECTORS (b)



SOURCES: OECD (PIAAC, 2013), INE and Banco de España.

a The skills mismatch index measures the difference in the percentages by educational attainment level of the total employed and unemployed.
b In Chart 13.2, a bar higher than 1 means that the corresponding sector uses a particular skill more intensely than in general, while a bar lower than 1 means that it uses it less intensely.

In more specific terms, there is a need to promote active job search, appropriate worker guidance and specialised and specific training when skills requirements are detected. To this end, mechanisms should be set in place to provide for monitoring and individualised guidance for the unemployed based on available statistical profiling techniques of unemployed workers and of local vacancies.

Improving the human capital of the lesser-skilled unemployed is key to facilitating their re-employment. Formulas should also be applied to counter possible spending cuts which firms might introduce in the short term in response to their liquidity needs, given the negative impact this would have on aggregate productivity subsequently.

Likewise, the possible changes in the sectoral structure of occupation make it advisable to reinforce continuous training, in itself desirable in the current setting of rapid population ageing.

Also, the recent increase in the resort to teleworking in some occupations may not be merely temporary, as an emergency solution during the pandemic. In this case, firms must invest in resources and knowledge to ensure the maximum productivity of these workers.

It would also be desirable to retain the possibility of entering into training contracts, with the greatest possible flexibility, for youths and firms, and to earmark funds for redesigning vocational training, in terms of an optimal combination of general training and practical experience in firms. The aim would be to facilitate the transition from the educational system to the labour market.

Finally, the current arrangements on hiring rebates should be reviewed and priority given to those aimed at the elderly and lesser-skilled, with ongoing monitoring of their effectiveness to adjust the less satisfactory aspects.

Employment adjustment mechanisms

As in other European countries, furlough schemes have been heavily resorted to from the onset of the current crisis, owing to the essentially transitory nature of the shock and to the measures adopted to make their use more attractive for firms and workers. This has led to the suspension of numerous contractual relationships, which should gradually resume as economic activity recovers.

Significantly, the recovery phase will be uneven across types of activity and companies. It will be necessary to maintain some support, for an additional period, to certain sectors and firms for which the negative impact of the current crisis may be somewhat more prolonged than initially anticipated.

In parallel, we must take into account the possible structural changes derived from the crisis, since different economic policy measures will be required to tackle them. Thus, evidence based on previous recession episodes, both nationally and internationally, illustrates that the effectiveness of the furlough schemes in safeguarding employment is lower the longer the crisis persists. In particular, this is so where restructuring at sector- or firm-level is required to adapt to a new context in terms of activity. In this respect, the proper functioning of the different flexibility mechanisms available for firms in the current legal framework should be ensured. These internal adjustment levers, duly calibrated to the current situation, are a valuable option for safeguarding the viability of many firms and, consequently, of the related jobs.[33]

33 For instance, certain past experiences advocate retaining the use of mechanisms for opting-out from agreed collective bargaining conditions, at least temporarily, particularly because the high inertia observed in collective bargaining processes might not adequately reflect the new post-pandemic economic conditions.

5. Addressing the challenge of population ageing

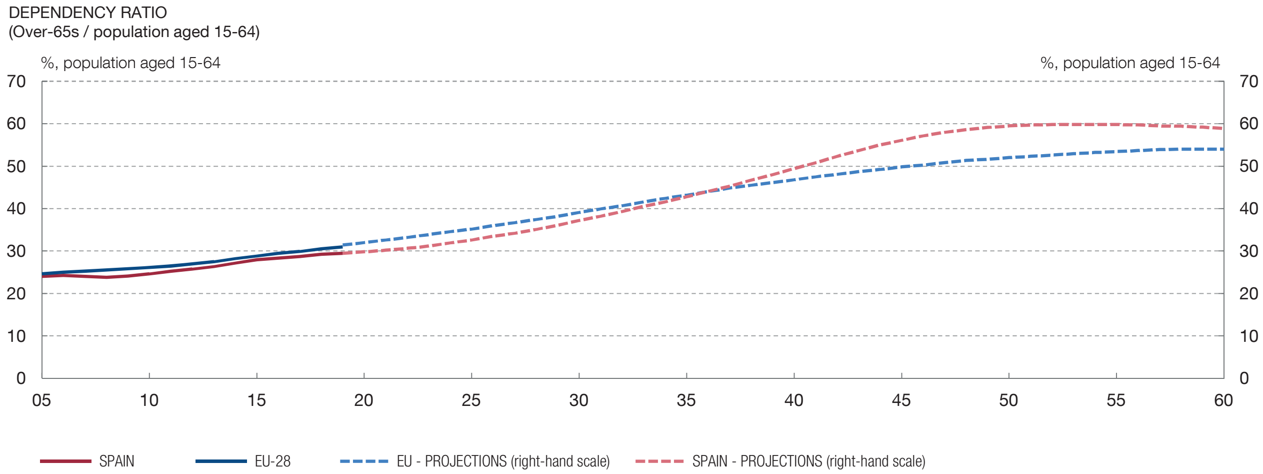
Population ageing is unquestionably one of the biggest challenges the Spanish economy must face, both from a short- and long-term perspective. The extraordinary scale of this challenge arises not only from the very magnitude of the demographic changes under way, but also from the numerous consequences these changes have in terms of the economy's growth capacity, the labour market and fiscal policy, among other aspects.[34]

True, demographic change is a challenge affecting most of the advanced economies. But it will have a particular bearing on our country. Allow me to illustrate this by plotting the dependency ratio, which measures the over-65s relative to the population aged 15-64.

On Eurostat data, the dependency ratio in Spain currently stands at 29.5%. This means that, as of today, 16 EU countries have a higher dependency ratio than Spain. Indeed, the overall euro area ratio is, at 31.4%, also above Spain's. However, Eurostat projections show that, in the next 25 years, the dependency ratio will increase by over 25 pp in Spain, to 56.1%. Even in the most optimistic demographic projections available, the dependency ratio would exceed 50% by mid-century. Spain will in fact be the EU country, according to Eurostat, experiencing the biggest increase in this ratio; and, in 2045, only Italy, Greece and Portugal will have a higher one than Spain's (the European average will stand at 49.8%).[35]

Chart 14

WHILE MOST ADVANCED ECONOMIES WILL BE AFFECTED BY DEMOGRAPHIC CHANGE, SPAIN WILL BE ESPECIALLY IMPACTED BY IT



SOURCES: Social Security, INE and Eurostat.

34 See: Banco de España (2019), "Economic consequences of demographic change", Chapter 4, *Annual Report 2018.*

35 See EUROPOP 2019 projections.

The factors behind population ageing are well-known and I do not intend to tackle them in depth in this address. Two brief facts will help understand these dynamics in our country. Life expectancy in Spain in recent years has been one of the highest internationally. Specifically, on the latest Eurostat data, a Spaniard at birth could expect to live to the age of 83.5 in 2018, more than the 81 years for the EU as a whole.

Set against this clearly positive aspect, the fertility rate in Spain, standing at scarcely 1.26 children per woman of childbearing age, is very low compared with other European countries. It is telling, moreover, that our fertility rate is also at some distance from that *desired* by women of childbearing age (1.96 children per woman).[36]

This calls for reflection, for instance on the advisability of introducing measures conducive to work-life balance, bolstering family support and increasing labour market opportunities, especially for young women with children since it is they who are frequently most affected economically by the decision to become mothers. Indeed, on the evidence available, a significant portion of gender-based wage differences stem from the time of maternity and are not fully corrected subsequently.[37] In addition, the restrictions associated with migratory policy should be regularly reviewed in an attempt to adapt them to labour market needs.

As mentioned, population ageing has implications for numerous socio-economic areas. In particular, there are extensive theoretical grounds and empirical evidence documenting how the demographic changes under way will affect consumption (and its composition), investment, employment, productivity, the economy's growth capacity and also wage- and price-setting. These changes, which were analysed in detail in last year's Banco de España *Annual Report,*[38] will also condition monetary policy effectiveness and, in the fiscal area, will affect both the level and composition of public spending and revenues.

As it is not possible to cover all the consequences in my address today, I shall focus on two aspects I consider significant for this Committee: the effects of ageing on public finances and on the economy's potential growth.

Both public revenues and spending will be extraordinarily affected in the coming years by population ageing, to which any budgetary policy and medium-term fiscal consolidation strategy should pay great heed.

As regards public revenues, household consumption, saving and investment decisions will clearly vary appreciably over their life cycle. Likewise, very significant differences will be perceptible in the level and composition of individuals' income and wealth

36 See Encuesta de Fecundidad 2018, INE.

37 See L. de Quinto, C. Sanz and L. Hospido, *The Child Penalty in Spain,* Occasional Paper, Banco de España.

38 See Banco de España (2019), "Economic consequences of demographic change", Chapter 4, *Annual Report 2018.*

based on their age. This suggests that, in a setting in which our demographic structure is to undergo far-reaching changes, the composition of tax bases and, therefore, of the current tax system's revenue-raising capacity will also potentially be greatly affected.

In particular, the return on previously accumulated assets usually accounts for a higher proportion of the income of older households than of younger households, whose labour income has a greater relative weight. Given that for many assets the taxation on saving is below that on employment income, this aspect will result in a lower aggregate tax take as a consequence of ongoing population ageing. Insofar as household income normally dips when retirement age is reached, the progressivity of personal income tax will also entail lower tax revenue.[39]

On the public spending side, increased longevity and the fact that the baby boomer generation is on the verge of retirement will exert considerable upward pressure on public finances.

On the latest Eurostat figures, for 2018, spending on health and on social protection in Spain, which includes transfers associated with retirement, survival and disability, inter alia, totalled 22.9% of GDP. Undoubtedly, the weight of these items in GDP will increase in the coming years. Thus, for example, the European Commission's 2018 report on ageing forecasts that, in 2050, spending on health and on long-term care will be almost 2 pp of GDP higher than that recorded in 2016.[40]

Tackling pension system reform

On pensions, the reform approved in 2013 included the application of a sustainability factor, linking the starting pension to the increase in life expectancy, and of an annual pension revaluation index, which linked its increase to the balance between the system's revenues and expenditure. In favourable macroeconomic settings, these mechanisms provided for a gradual reduction in the system's deficit, significantly countering the effect on pension spending of the expected increase in the dependency ratio in the long term. However, in the absence of further increases in revenues, the adjustment would mainly be through a reduction in the replacement rate of public pensions, the decline in which could amount to 20 pp between 2013 and 2060.[41]

The latest measures adopted in this connection have partially suspended the application of these mechanisms, with the activation of the sustainability factor being delayed until 2023 and with the return to an annual pension revaluation system in line with

39 See R. Ramos (2019), "Los retos del envejecimiento para los ingresos públicos: la composición de las bases fiscales", *Revista Actuarios,* no. 44, primavera, pp. 36-39.

40 See European Commission (2018), *The 2018 Ageing Report. Economic & Budgetary Projections for the 28 EU Member States (2016-2070),* Institutional Paper 079, May.

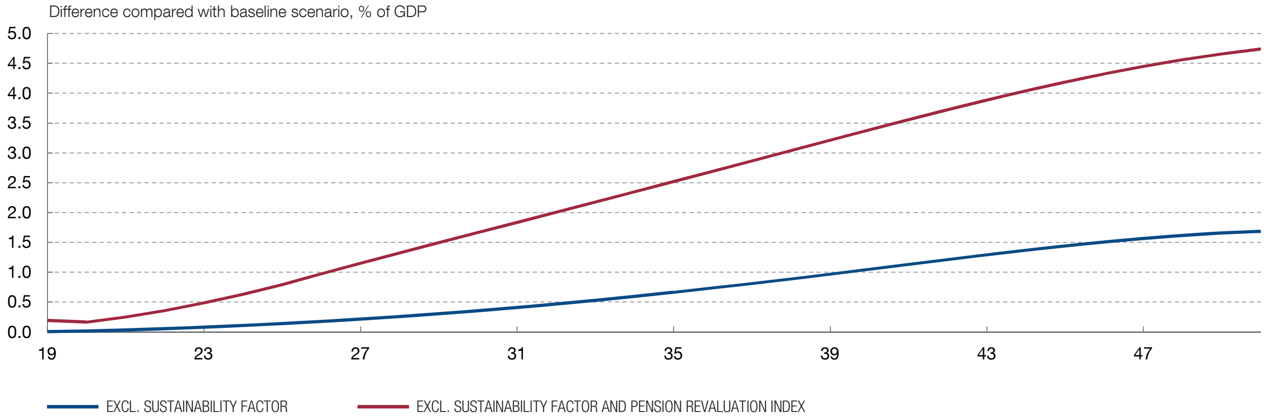
41 See R. Ramos (2014), "The new revaluation and sustainability factor of the Spanish pension system", *Economic Bulletin,* July-August, Banco de España, and P. Hernández de Cos, J. F. Jimeno and R. Ramos (2017), *The Spanish public pension system: current situation, challenges and reform alternatives,* Occasional Paper No 1701, Banco de España.

the CPI. Against this background, further measures will be needed to shore up the financial sustainability of the public pension system. The debate which must be considered here should address the level of benefits the public pension system should provide, and ensure the mobilisation of sufficient funds to afford them. Insofar as a greater need for funds may entail an increase in the burden placed on present and future younger generations, this debate should take into account not only the cohorts closest to retirement age but also the young, establishing basic parameters of intergenerational fairness.

Chart 15

POPULATION AGEING WILL EXERT SUBSTANTIAL UPWARD PRESSURE ON PUBLIC SPENDING, PARTICULARLY ON PENSIONS

PROJECTED SPENDING ON PENSIONS



SOURCES: Own calculations based on the General Social Security Law.

Among the various measures that could be adopted, it would be advisable to increase the system's transparency and strengthen the link between contributions made and benefits received, while constantly ensuring a level of sufficiency for those households with more limited resources. It would also be desirable to introduce new incentives that help better align the actual and legal retirement ages.

Establishing automatic adjustment mechanisms helps stabilise the system, adapting it to demographic and economic changes. In this respect, and precisely to ensure the sustainability of the system, several EU countries, such as Germany, Sweden and Italy, have established a link between the level of benefits or retirement age and life expectancy.

There is also room for calm reflection on the role that complementary private saving mechanisms should play. Their development in Spain is very limited compared with other Northern European economies, and they could help complement public pensions.[42]

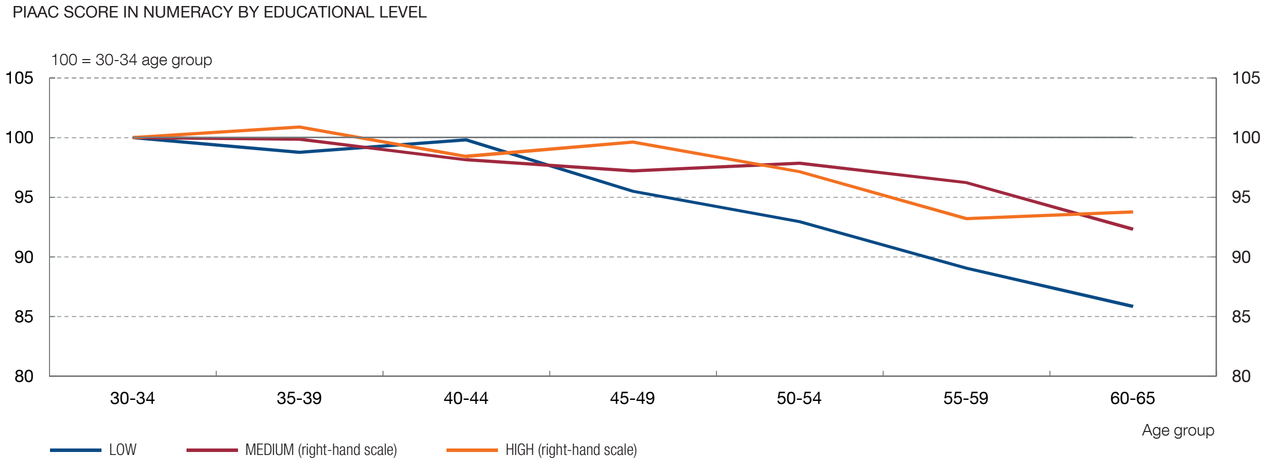
42 See OECD (2019), *Pensions at a Glance 2019: OECD and G20 Indicators,* OECD Publishing, Paris.

Before concluding this section, I would like to mention the challenges population ageing also poses in terms of the economy's potential growth, through its impact on the labour market and worker productivity.

It is worth stressing here that the labour market participation rate varies appreciably depending on age, tending to fall for ages close to retirement. Part of this is because people's physical and cognitive skills worsen over time, entailing a reduction in their productivity and added difficulty when performing specific tasks.[43]

Chart 16

POPULATION AGEING WILL ALSO AFFECT THE ECONOMY'S POTENTIAL GROWTH VIA A DOWNTURN IN SKILLS



SOURCE: OECD (PIAAC, 2013).

We are in a setting in which our population is ageing and, at the same time, most intense technological change is under way. This will require increasingly greater levels of numeracy, data management and the adoption of digital technologies. Against this background, we must prevent sizeable segments of our working population from falling behind. If we fail to do so, our growth capacity will undoubtedly be impaired, not only in the medium term but also in the short run, and this will hamper the sustainability of the pension system.

It is thus vital to insist on the need to foment investment in innovation, but also in education and lifelong learning at work. In terms of working conditions, boosting teleworking may also have a key role to play here given that, on the evidence available, it is seen as more attractive and is used more frequently by older workers.[44] It would also be advisable

43 See B. Anghel and A. Lacuesta (2020), "Ageing, productivity and employment status", Analytical Articles, *Economic Bulletin,* 1/2020, Banco de España.

44 See, for example, P. Hudomiet, M. D. Hurd, A. Parker and S. Rohwedder (2019), *The effects of job characteristics on retirement,* NBER Working Paper No. 26332; Office of National Statistics (2019), *Coronavirus and homeworking in the UK labour market,* and INE (2020), *El teletrabajo en España y la UE antes del COVID-19.*

to reconsider working conditions so they might smooth cross-occupational switches by workers during their career, as these have been demonstrated to help increase productivity and allow for longer labour market participation.

I would not wish to conclude this section without also mentioning the opportunities the demographic challenge offers for the development of certain sectors in the medium term. These include most notably health, recreation, tourism, real estate and finance. Spain enjoys a favourable starting point to compete in the provision of services intended for the elderly (what has been called the "silver economy"[45]). This is in light of our special geographical and cultural conditions, and the pattern of sectoral specialisation developed in recent years. Harnessing these new opportunities will require a flexible, nimble approach, on the part of the public and private sectors alike, and the pursuit of continuous improvements in quality and efficiency in providing the goods and services that a more aged society demands.

45 See European Commission (2018), *"The Silver Economy"*, a report by Technopolis and Oxford Economics for the European Commission's Directorate-General of Communications Networks, Content & Technology.

6. Strengthening inclusion policies

I will now address the challenge posed by the increase observed in inequality for the Spanish economy. This challenge is shared by many other European economies. As you know, a society's level of inequality may be assessed through various variables, e.g. in terms of opportunities, wages, income, consumption and wealth.

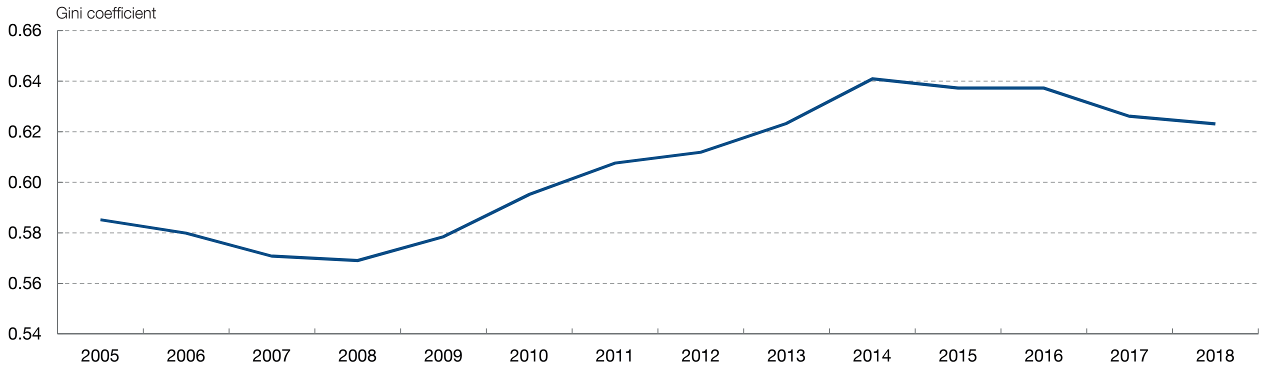
In some of these, a certain level of inequality may be considered inherently natural for the proper functioning of a market economy. It may reflect, for instance, differences in worker productivity or different preferences regarding work versus leisure or saving versus consumption throughout people's life cycles. However, there is evidence that excessive inequality may adversely affect not only the degree of social cohesion, but also agents' decisions on spending, investment and human capital accumulation. In other words, excessive inequality frequently weighs on economic growth and on its sustainability.[46]

The global financial crisis gave rise to a significant increase in wage income inequality in Spain between 2008 and 2014. Since then, against a background of robust and uninterrupted economic growth until the outbreak of the pandemic, enabling almost three million jobs to be created and a notable reduction in the unemployment rate, income inequality has declined. However, the level of inequality with which we are facing the COVID-19 crisis is above that in place at the end of the expansionary cycle prior to the 2008 crisis.

Chart 17

SPAIN FACES THE CURRENT CRISIS WITH A HIGHER LEVEL OF INEQUALITY THAN AT THE END OF THE PREVIOUS EXPANSIONARY CYCLE (2007)

GINI COEFFICIENT OF TOTAL HOUSEHOLD WAGE INCOME



SOURCES: INE (Survey of Income and Living Conditions) and Banco de España.

46 See A. V. Banerjee and E. Duflo (2003), "Inequality and Growth: What Can the Data Say?", *Journal of Economic Growth,* 8, pp. 267-299.

In particular, the level of income of certain groups in the lower part of the wage distribution, such as the under 35s, was still 20% below its 2007 level in 2018. This has essentially been the result of the reduction in the average duration of temporary contracts, something excessively frequent in this group, and of the increase in the degree of involuntary part-time working, in many cases.[47]

In terms of wealth, inequality increased in Spain even after 2014, in part owing to the change in the savings pattern of young households. Indeed, according to the latest wave of the Survey of Household Finances (EFF) 2017, which the Banco de España prepares regularly, in the last few years a high percentage of youths continue to live in their parents' home and those who decided to leave the family home did so mostly through rent (in part, owing to the difficulties in housing affordability). This has influenced their wealth accumulation profile.[48]

All the indications are that the COVID-19 crisis will further worsen the levels of inequality in Spain. In particular, the latest international evidence suggests that the labour income most affected by the lockdown measures adopted in most of the countries affected by the pandemic was that of the groups starting from a more vulnerable position, such as women, the young or social groups with a low level of educational attainment. This appears to be the result of lockdown having had a bigger effect on workers who need to be physically present to perform their tasks and on those who work in occupations that require closer contact with other people. The workers who are occupied in jobs of this kind are precisely those with lower educational attainment levels, lower salaries and more job insecurity, on average.[49]

Spain is no stranger to this characterisation and, as certain Banco de España analytical papers note, among the employed in the sectors most affected by the social distancing measures, the proportion of women, youths and the less-skilled is higher.[50] The effects of this crisis on the ability to maintain a sufficient level of educational quality, which would be uneven among students on the basis of their capacity to access technology, could also generate time-persistent effects on inequality.

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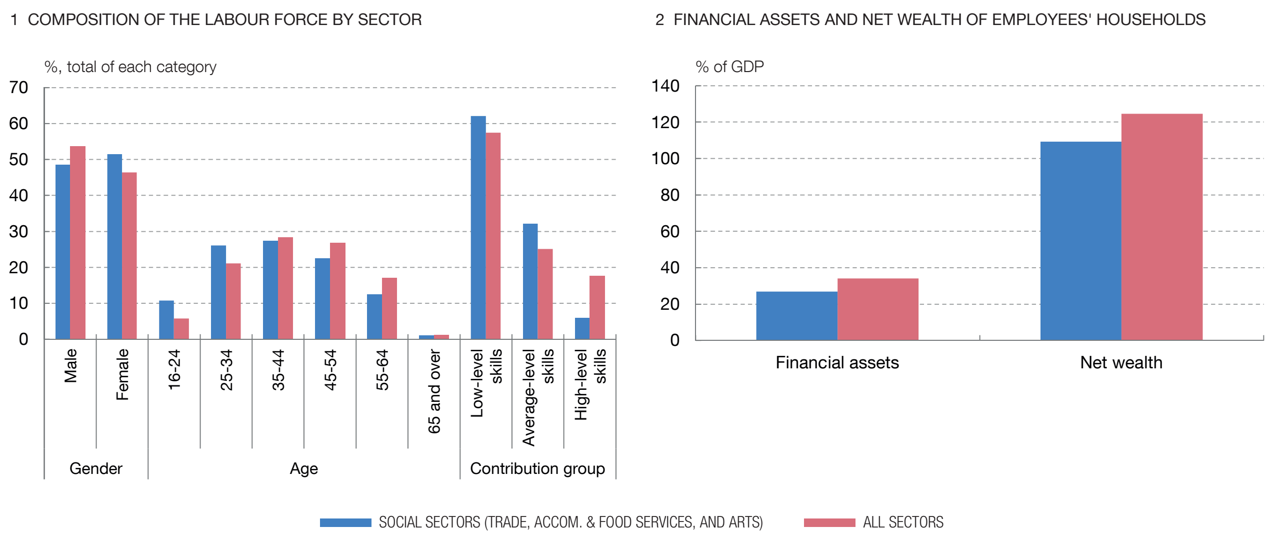
47 S. Puente and A. Regil (2020), "Intergenerational employment trends in Spain in recent decades", Analytical Articles, *Economic Bulletin,* 2/2020, Banco de España.

48 The percentage of heads of household under 35 who owned a property fell by 8 pp between 2014 and 2017. See Banco de España (2019), "Survey of Household Finances 2017: methods, results and changes since 2014", Analytical Articles, *Economic Bulletin,* 4/2019, Banco de España. For further details on changes in the real estate market, see also Directorate General Economics, Statistics and Research (2020), *The housing market in Spain: 2014-2019*, Occasional Paper No 2013, Banco de España.

49 See S. Mongey, L. Pilossoph and A. Weinberg (2020), *Which workers bear the burden of social distancing policies?,* NBER Working Paper No. 27085 for the United States. For The Netherlands, see H. M. von Gaudacker, R. Holler, L. Janys, B. Siflinger and C. Zimpelmann (2020), *Labour supply in the early stages of the COVID-19 pandemic: empirical evidence on hours, home office, and expectations,* IZA DP No. 13158; for Germany, see J. V. Alipour, O. Falck and S. Schuller (2020), *Germany's capacities to work from home,* IZA DP No. 13152; and for the United Kingdom, see A. Adams-Prassl, T. Boneva, M. Golin and C. Rauh (2020), *Inequality in the impact of the coronavirus shock: evidence from real time surveys,* IZA DP No. 13183, and B. Bell, N. Bloom, J. Blundell and L. Pistaferri (2020), *Prepare for Large Wage Cuts if you are Younger,* VoxEU.

50 See B. Anghel, A. Lacuesta and A. V. Regil (2020), "Transferability of workers' skills in sectors potentially affected by COVID-19", Analytical Articles, *Economic Bulletin,* 2/2020, Banco de España.

Chart 18
THE CURRENT CRISIS IS HAVING A GREATER IMPACT ON THE MOST VULNERABLE COHORTS; INEQUALITY WILL RISE AS A RESULT



SOURCES: Ministerio de Inclusión, Seguridad Social y Migraciones, and Banco de España.

As regards the degree of vulnerability of these workers, I wish to highlight two very significant aspects inferred from the Banco de España's EFF analysis. First, for 50% of workers in "social industries" (those hardest hit by the lockdown measures), household savings represent less than 3.3 months of their total income.[51] This gives an idea of the impact which persistent job destruction in these sectors would have on the living conditions and demand of these households.

Second, on a more positive note, the EFF suggests that in this crisis families would be more capable of cushioning the impact on the most affected workers than during the previous crisis. In particular, in the 2008 crisis the employment income of 50% of workers in the construction sector (those most affected by that crisis) was that of the main breadwinner (i.e. these workers contributed at least 50% of household income). However, in the current crisis only one-third of workers employed in industries with a strong social interaction component were the main breadwinners for their homes. This is mainly because the social industries employ many young workers who have not yet left the family home and many women who, according to this evidence, are not the primary breadwinners for their homes.

The measures aimed at protecting employment and supporting household income approved in response to this crisis will contribute to reducing the vulnerability of the most

51 See P. Alvargonzález, M. Pidkuyko and E. Villanueva (2020), "The financial position of the workers most affected by the pandemic: an analysis drawing on the Spanish Survey of Household Finances", Analytical Articles, *Economic Bulletin,* 3/2020, Banco de España.

affected households.[52] To the extent that some of the adverse effects of this crisis will extend over time, it seems appropriate to maintain over a broader horizon than initially anticipated some of these measures supporting employment and income for the most vulnerable households. Nonetheless, at the time of implementing a possible extension of these actions it is essential that they remain focused and temporary. To be avoided here would be any inefficient delay in the structural adjustments to be made in certain sectors or firms (for instance, in the case of furlough schemes) or a permanent distortion of the decisions relating to certain groups' labour market participation (such as in the case of certain subsidies) as a result of these support measures.

It should also be highlighted that many of the structural measures mentioned previously in connection with, for instance, the need to improve productivity dynamics and to reduce unemployment or job insecurity are also essential to reduce inequality in Spain.

Pushing through an appropriately designed and applied minimum living income

The minimum income scheme (MI) recently approved at State level could contribute, in coordination with regional schemes, to reducing the level of extreme poverty of groups with special difficulties in accessing the labour market. Here it will be essential, as with any other economic policy measure, to assess its practical application, together with the ongoing and rigorous monitoring of its functioning, cost and the fulfilment of its stated goals.

In particular, once the regulatory implementation of this measure is known, it will be important to assess how it may overlap with, or supplement, other forms of assistance already available at the central, regional and local levels, for the purposes of ensuring efficiency in the use of public funds across all tiers of government. It must also be clear whether the eligibility requirements laid down in its current design are effective in providing assistance to those groups that are truly more vulnerable or whether the access criteria need to be recalibrated to provide a more precise picture of the genuine degree of need of the beneficiaries. Such is the case with the asset-holding thresholds, which should probably include some type of information requirement about the applicant's level of debt.

Moreover, there should be close monitoring of whether this instrument, as it involves a permanent transfer, may ultimately prompt unwanted effects, e.g. in terms of the future income-generating capacity of beneficiaries. To mitigate this unwanted effect, the MI's design allows for the temporary maintenance of at least a portion of the subsidised amount

52 The main measures adopted are set out in four Royal Decree-Laws (RDL 7/2020, RDL 8/2020, RDL 11/2020 and RDL 15/2020), approved between 12 March and 21 April. These measures notably include greater flexibility in layoffs and short-time work arrangements, and the exemption of employer social security contributions (100% in the case of SMEs and 75% for all other firms). Also worth mentioning is the introduction of an extraordinary unemployment assistance benefit for various groups, such as temporary workers with an insufficient previous contribution period and domestic service workers. The conditions for drawing the discontinuation of activity benefit for the self-employed have been relaxed, removing certain eligibility requirements, and greater unemployment protection has been afforded to permanent seasonal workers, expanding coverage to those who have been unable to start work and were not entitled to claim the benefit. Among other measures for the most vulnerable households, supplies of essential utilities have been guaranteed and different moratoria have been established for rent payments and mortgage and non-mortgage loan repayments.

when the beneficiary finds work. Looking ahead, it will be necessary to accurately assess whether this measure fulfils its goals. Another possible unwanted effect warranting special monitoring and control relates to the possibility, in certain cases, of this measure prompting a switch from certain economic activities to informal sectors.

At the same time, we should be mindful that the MI is not designed as an automatic stabiliser that generally softens adverse household income shocks. Thus, for instance, in crisis situations like the current one, there will probably be groups most adversely affected by the pandemic but who do not meet MI eligibility criteria. Therefore, the extraordinary maintenance of income in the current situation should continue to be supported by unemployment benefits and ad hoc measures which, in any event, should provide adequate incentives for compatibility with participating in the labour market.

Bolstering housing affordability policies

A further question concerns housing affordability having become harsher for certain groups in recent years, especially as regards the rental market. This phenomenon particularly affects vulnerable groups, such as the young, and may even adversely influence aspects such as the rate of new household formation, the fertility rate and regional mobility decisions. Once again, some of the aforementioned shortcomings of the Spanish labour market will have influenced these observed dynamics in the housing market. And the surge in rental prices in recent years, particularly so in specific cities and regions that have witnessed strong increases in demand, will also have been a contributing factor.[53]

Rental housing affordability problems for certain groups are a global phenomenon which is particularly noticeable in the metropolitan areas of the advanced economies. Against this backdrop, international experience relating to public policies in the rental housing market may provide useful insight into the design of these types of interventions, their possible unwanted effects and the need to assess their interaction with other labour or fiscal policies.[54]

In particular, the experience of other European countries shows that policies aimed at increasing the supply of rental housing are, in general, the most effective in tackling the current housing affordability problems, since these are largely derived from the existing gap between a growing demand for, and an insufficient supply of, rental housing. In certain countries, public authorities have boosted the available supply of rental housing, sometimes directly and sometimes by means of incentive-based mechanisms, and public and private collaboration schemes. As regards direct public intervention, the complex implementation and high budgetary cost which the creation of a large stock of public housing entails explain

53 For a description of the significance of the factors driving the demand for rental housing in certain geographical areas to outpace supply, see D. López-Rodríguez and M. Ll. Matea (2019), "Recent developments in the rental housing market in Spain", Analytical Articles, *Economic Bulletin,* 3/2019, Banco de España.

54 A review of international experience and of the assessments available of rental housing market policies can be found in D. López-Rodríguez and M. Ll. Matea (2020), *Public intervention in the rental housing market: a review of international experience,* Occasional Paper No 2002, Banco de España.

the reversal of this policy internationally in recent years. Against this alternative, in other recent cases the option has been to combine the introduction of public guarantees with tax incentives for the rental housing developer private sector to foster access to housing in more advantageous conditions than those offered in the free market to groups mainly comprising youths and low-income households.

The international evidence has also shown the importance, for the purpose of developing a broad rental market, of ensuring legal certainty for owners. The existence of a stable regulatory framework that preserves legal security in this market is necessary to increase both professionalism in the sector and the volume of investment in residential rental housing, thus allowing for a substantial and stable increase in the supply of rental housing over a reasonable period.

Finally, the experience in some large cities in Europe and in the United States has also evidenced that intervention based on price control has frequently been ineffective in durably addressing the problem of an insufficient supply of rental housing. In this connection, although price ceilings may be useful for alleviating the burden of rentals on the expenditure of households residing in regulated properties, this measure does not foster an increase in the supply needed to absorb the rise in demand and to thus curtail price dynamics in the medium term. At the same time, these types of policies may give rise to significant adverse effects through a reduction in the supply of rental housing, a decrease in property maintenance expenditure and an increase in rental prices in unregulated segments. This may even lead to situations where there is a risk of strong geographical segmentation of the population according to socio-economic conditions within the cities.[55]

55 The specialised literature has extensively documented the adverse effects which residential housing rent control may have. See, among others, D. Autor, C. J. Palmer and P. A. Pathak (2014), "Housing market spillovers: evidence from the end of rent control in Cambridge, Massachusetts", *Journal of Political Economy,* 122(3), pp. 661-717.; R. Diamond, T. McQuade and F. Quian (2019), "The effects of rent control expansion on tenants, landlords, and inequality: evidence from San Francisco", *American Economic Review,* 109(9), pp. 3365-3394; or E. Glaeser and E. Luttmer (2003), "The misallocation of housing under rent control", *American Economic Review,* 93, pp. 1027-1046.

7. Smoothing the transition to a more sustainable economy

Climate change and the transition to a more sustainable economy are some of the main challenges our society faces. This truly global challenge affects all social and economic agents, and requires a deep-seated change in production methods and consumption habits.

In recent years, both the EU and Spain have taken an active position in combating climate change and, in particular, in favour of implementing the Paris Agreement.[56] In late 2019, the European Commission unveiled the European Green Deal[57], which includes an extensive package of measures seeking to attain climate neutrality in the EU in 2050 and to raise the emissions-reduction target for 2030. Further, the EU has played a key leadership role in seeking internationally coordinated action to counter climate change.

With respect to Spain, last May the Government submitted the first draft Law on Climate Change and Energy Transition to Parliament. As in Europe's case, this draft legislation set highly ambitious environmental targets for the future. In particular, the plan is aiming on a 20% reduction in greenhouse gas emissions by 2030 relative to the 1990 level (entailing a reduction of 33% relative to the 2017 level), a 35% improvement in the country's energy efficiency, and with renewable energies accounting for 35% of final total energy consumption.[58] Looking further ahead, the aim is that climate neutrality be achieved no later than 2050 and that the electricity system should be 100% renewable.

Achieving these goals will be no mean task and will call for an internationally coordinated and comprehensive strategy to promote investment in less pollutant technologies, to avoid regulatory uncertainty, and to minimise delocalisation risks and adaptation costs. According to some sociological studies, Spanish society appears to be aware in the main of the risks of not taking immediate action in the fight against climate change. It also seems ready to assume some of the potential costs arising from these measures.[59]

The role of fiscal policy

Fiscal policy can and should play a leading role in managing the transition to a more sustainable economy. Governments and parliaments, as guardians of the public's trust, have the necessary legitimacy to pave the way for this transformation process. And, moreover, they have the most appropriate instruments to make it happen. Indeed, setting and calibrating taxes and subsidies so that they equalise marginal private and social costs

56 This agreement seeks to prevent global warming exceeding pre-industrial levels by 2ºC and to increase efforts to restrict it to around 1.5 ºC.

57 See A European Green Deal (European Commission).

58 As part of the 2020 Europe Strategy, Spain's climate change and energy targets for 2020 included a reduction in greenhouse gas emissions of 10% (with respect to 2005 levels), an increase in the proportion of renewable energies in final energy consumption of up to 20% (with respect to 1990 levels), and a 20% reduction in energy consumption (in relation to the 2007 trend level). Foreseeably, the greenhouse gas emissions target will be met in 2020 and the two other objectives will be close to the thresholds set.

59 See Real Instituto Elcano (2019), *Los españoles ante el cambio climático. Apoyo ciudadano a los elementos, instrumentos y procesos de una Ley de Cambio Climático y Transición Energética*.

is the most efficient means for economic agents to internalise the environmental externality that their activities generate.[60] In this respect, environmental taxation should be centre-stage in tackling the challenges of climate change.

This is the thrust of various initiatives currently under discussion. For example, the main tool envisaged in the European Green Deal to achieve the objectives proposed is the Emissions Trading System (ETS). This system seeks to set a price for emissions rights that will act as a deterrent to using carbon rather than less pollutant energies. In 2019, the price of these rights was still at levels some distance off the references some agencies consider appropriate for reaching the Paris Agreement objectives. With the aim of attempting to close this gap, the European Green Deal extends ETS to more sectors in the economy, such as transport, the maritime sector and construction, and it reduces the volume of emissions permitted within the system at a greater pace.

As a complement to the emissions system, the Commission has also proposed the introduction of an at-border adjustment to the cost of carbon. This would attempt to prevent firms from transferring their production to countries with less demanding environmental regulations. Other initiatives are geared to reducing emissions in the transport sector (by eliminating subsidies for the use of fossil fuels and tightening car pollution regulations) and to promoting recycling and innovation in clean technologies.

In any event, it is worth highlighting that, in respect of environmental taxes, there are currently notable national differences within the EU, both in terms of the type and scope of the instruments used. Looking ahead, it would be advisable to increase the degree of European harmonisation in the use of environmental taxes.

The role of fiscal policy in combating climate change is not confined exclusively to the tax realm: increasing public investment will be key. Thus, for example, although the European Green Deal seeks to mobilise investment worth €1 trillion in 10 years (approximately 0.5% of European GDP per annum), the European Commission's own estimates suggest that reaching the EU's climate targets would call for additional annual investment equivalent to 1.5% of European GDP. As I have said, it is precisely in innovation projects, such as those related to the development of cleaner and more efficient new technologies, and at times of uncertainty, as at present, when public investment must act as a catalyst. This is liable to generate significant positive externalities both on private-sector investment and on the overall economy's growth potential.

Fiscal policy could also be used to compensate those agents that may be adversely affected in this ecological transition process. Economic policy should acknowledge that, in the transition to a more sustainable economy, there will be population groups, regions

60 This is precisely the essence of the *Carbon Dividends Plan* proposal promoted by the Climate Leadership Council. The Plan asserts that "a carbon tax is the most efficient lever in terms of cost for reducing carbon emissions on a scale and at the speed needed".

and sectors whose well-being will inevitably be diminished, at least in the short term. In particular, attaining the climate goals will require very different efforts by the different sectors of activity. In this respect, it is imperative that those agents or sectors more vulnerable to the measures in place to tackle climate change be properly identified, and that effective and efficient policies be implemented to mitigate the potential adverse effects on them. One possibility would be to use the environmental tax revenue obtained to smooth the process of adjustment for these groups in the short term.

In short, fiscal policy should in our view play a pre-eminent role in the management of climate change. It should do so to deter the most harmful activities to the environment and to boost the public and private investment needed to develop cleaner technologies, and also to alleviate the social costs of the transition.

The role of the financial system

The financial sector is also called on to play a key role in the transition to a more sustainable economy. It is crucial here that the sector should incorporate climate change-associated risks – physical and transition-related alike – into its decision-making process and identify the opportunities opening up in this transformation. Only by properly assessing these risks and opportunities may the financial sector contribute to the swift and efficient shift in resources between savers, sectors and firms that the transition to a more sustainable economy requires.

Supervisors must ensure that banks correctly price the risks associated with climate change and incorporate them into the management of their portfolios. Many initiatives are under way along these lines.[61] In particular, supervisory guidelines are being drawn up in order to align the approach different banks are using to treat these risks. Many supervisors (including the Banco de España) are also developing environmental stress tests. Their aim is to introduce them in the coming years and analyse the consequences for the financial institutions of different scenarios entailing changes in the structure of the economy. The challenges here are manifold, especially in respect of information and modelling. In terms of information, there are notable gaps that must be plugged as soon as possible. On one hand, only large corporations have estimated their carbon footprint and, among these, practically none estimates this footprint including the inputs incorporated into their productive processes. On the other, in Spain's case, there is no centralised register of energy ratings of homes, the heating and cooling of which accounts for around 25% of total greenhouse gas emissions.

From a cross-cutting standpoint, the challenges in terms of modelling are no less in scale. This is because of the need to incorporate both a sectoral and time-based dimension into the models, since the horizon of the scenarios must be increased beyond what is usually

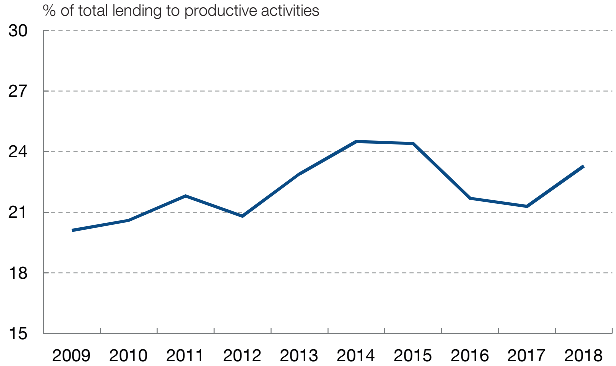
61 In the central banking and banking supervision domains, there has been notable coordination work by the Network for Greening the Financial System (NGFS), of which the Banco de España has been a member since 2018. Further, the Basel Banking Supervision Committee decided, in October last year, to start work on the financial risks associated with climate change, while the Single Supervisory Mechanism has resolved to include climate risks in its map of risks for 2020 as a basis for defining its supervisory priorities. Moreover, it is worth highlighting the work by the Financial Stability Board (FSB) to promote the publication of consistent and comparable climate risk-related financial information by firms.

required by monetary policy or financial stability. Further, as with any structural change, the past may prove not to be very useful for predicting the future; it is thus necessary to consider different climate transition scenarios and to analyse their implications, irrespective of how different economic agents may have behaved in the past.

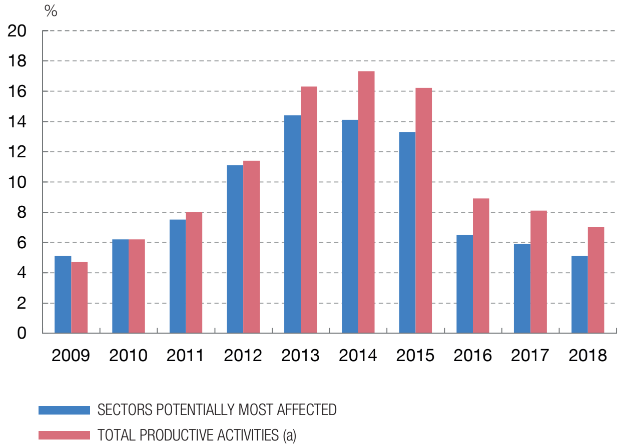
Chart 19

SPANISH CREDIT INSTITUTIONS ARE MODERATLEY EXPOSED TO THE SECTORS MOST AFFECTED BY TRANSITION RISKS

1 EXPOSURE OF THE SPANISH BANKING SYSTEM TO THE SECTORS OF ACTIVITY POTENTIALLY MOST AFFECTED BY THE ENERGY-TRANSITION RISKS



2 NPL RATIO BY SENSITIVITY OF THE SECTORS OF ACTIVITY TO ENERGY-TRANSITION RISKS



SOURCE: Own calculations drawing on Banco de España data.

a Excluding construction and property development.

Spanish credit institutions are moderately exposed to the sectors of activity potentially most affected by transition risks.[62] In particular, lending extended by Spanish banks to these sectors account for around 20% of their portfolio of loans to productive activities. Since the global financial crisis, the non-performing loans ratio in the sectors has been lower than that observed in other productive sectors. This would partly be the consequence of some of the sectors most exposed to transition risks posting above-average unit profits. To the extent that, as part of the ongoing transition to a more sustainable economy, these sectors are obliged to internalise the environmental costs they generate, they could see their profitability differential decline, while their perceived credit market risk would rise in relation to that of other sectors of activity. Credit institutions must take these considerations into account.

Supervisors must also collaborate in developing the capital markets infrastructure needed to smooth the ongoing cross-sectoral and cross-firm reallocation of financing, so

62 This category includes those sectors of activity whose annual CO2 emissions exceed 0.11 kg per euro of value added. This group includes several transport segments, electricity production, oil refining, the chemical industry, metallurgy, the manufacture of non-metallic products, paper, timber, food, textiles and agriculture. Overall, these sectors account for 20% of the Spanish economy's value added and 18% of employment. It is important to highlight that not all the firms in the sectors are equally pollutant.

that these markets may complement credit institutions in this effort. In this connection, financial markets are progressively developing debt instruments linked to the green economy. Currently, investor demand for this type of product exceeds supply, which has contributed to these instruments enjoying something of a “green premium”, which recently appears to be increasing. In collaboration with other institutions and with financial market players, supervisors should contribute to the development and international harmonisation of a sufficiently dynamic and detailed taxonomy. Such a taxonomy would add transparency to those activities (and products) that contribute to the transition to a low-carbon economy, and those that are more exposed to climate change risks. Also, supervisors should play an active role in the initiatives under way and seek to develop a robust and internationally consistent framework for the dissemination of financial information relating to climate matters.

Also under consideration is the possibility that central banks, within the financial regulation and monetary policy framework, could play a more proactive role in the transition to a more sustainable economy. They could do so by penalising the most pollutant sectors or initiatives (dubbed “browning”) or by favouring their cleaner counterparts (“greening”). In this respect, I would note, as I said earlier, that it should be fiscal policy which plays the central role in combating climate change. Naturally, it falls to us regulators and monetary authorities to contribute to this common goal, but only to the extent that it does not interfere in the fulfilment of our primary objectives: financial stability in the case of regulation, and price stability in the case of monetary policy. Here, the explicit inclusion of environmental aspects in the conduct of these policies should be justified by the fact that there is a clearly identified risk differential between different types of activities based on their greater or lesser environmental sensitivity, or because these activities entail an asymmetric impact in terms of their aggregate price dynamics.

In any event, within the Eurosystem we have currently embarked on a strategic review of our monetary policy. As part of it, we are going to reflect on how we can include climate risks and foment the sustainability of the economy. In this connection, it is first necessary to improve our understanding of the implications that climate change and the economic policies geared to mitigating it may have on the economy overall and, in particular, on price stability. The overarching aim is to incorporate these implications into the economic analysis and forecasting tools underpinning our decision-making process.

However, while we proceed with these reflections within the Eurosystem, the Banco de España has already approved the inclusion of sustainability and accountability criteria in its investment policy in respect of the reserves it manages. As part of this drive, and under our mandate, we are progressively increasing our own holdings of green bonds. Furthermore, by way of example, we are one of the founding members of the green investment fund set up by the Bank for International Settlements in Basel.

8. Maintaining a sound financial sector

I will now discuss the main challenges that the Spanish financial sector should address in the short, medium and long term. I described in detail the particularities of these challenges during my appearance before the Parliamentary Committee for Economic Affairs and Digital Transformation on 18 May. However, allow me first to briefly remind you of the significant transformation of this sector over the last eight years, from the standpoint both of its structure and the financial situation of the intermediaries comprising it, and of the regulation and supervision applicable.

Within the financial system, the Spanish banking sector was particularly affected by the global financial crisis and the euro area sovereign debt crisis. Since then, it has undertaken a far-reaching process of restructuring, concentration and write-downs.[63] The consequences of this process are visible in several dimensions. For example, there has been a significant decrease in the number of institutions and their capacity, measured both in terms of branches and employment and of bank balance sheet size.[64]

In parallel, the quality of banks' balance sheets has improved progressively, as reflected, for example, by the fall in the NPL ratio for loans granted to the non-resident private sector, from a record 13.8% at end-2013 to 4.8% at end-2019. However, it was still above the level recorded prior to the global financial crisis. The average solvency of banks has also improved, with an increase in the CET1 capital ratio of 1.5 pp between 2015 and 2019, excluding transitional adjustments. Banks' average return on equity also rose in these years, although in 2019 it was still below the figures prior to the global financial crisis and the cost of capital, a phenomenon that was even more acute in other European banking systems.

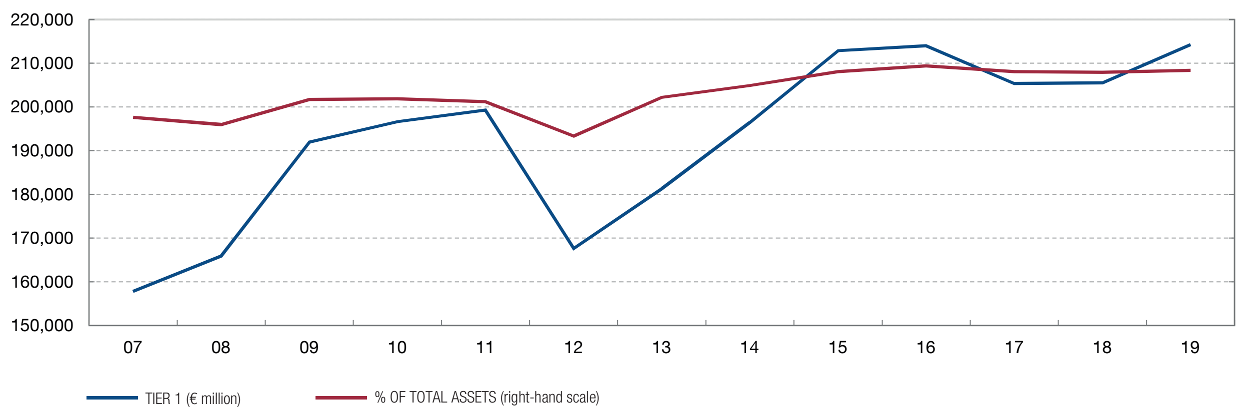
Significantly, at the same time as the transformation process was under way in the banking sector, the relative weight in the financial system of non-banking intermediaries progressively increased. Thus, as at December 2019 the non-banking financial sector accounted for 34% of the assets of all financial intermediaries (excluding central banks). Investment funds and pension funds are the non-banking intermediaries that have most grown since 2014. This has likewise been witnessed in the rest of the advanced economies and is in response to different factors, conjunctural and structural alike. In any event, it is a key part in the transformation the financial system has undergone in recent years. As we tend to recall in our *Financial Stability Report,* it should be taken into account when assessing the performance of the financial sector's aggregate dynamics, since interdependencies among intermediaries are very intense and increasingly greater.

63 For a detailed description of this process, see, for instance, *Report on the financial and banking crisis in Spain, 2008-2014* and *Annual Report 2017,* both published by the Banco de España. For more recent changes in this sector, see the *Financial Stability Report,* spring 2020, of the Banco de España.

64 From the 2008 peak until March 2020, the number of employees and branches has declined by 48% and 35%, respectively.

Chart 20
THE SPANISH BANKING SYSTEM HAS INCREASED THE QUANTITY AND QUALITY OF ITS CAPITAL IN RECENT YEARS

CET1 CAPITAL AND ITS PERCENTAGE OF TOTAL ASSETS



SOURCE: Banco de España.

Finally, financial regulation and supervision have also changed most significantly in recent years. Broadly, the main regulatory developments that followed the international financial crisis to bolster the financial soundness of the system can be summarised as follows: increase in the amount and quality of capital required of credit institutions to ensure greater loss-absorption capacity; improvement in the identification of certain risks in specific exposures (such as those associated with the trading portfolio, securitisations, exposures and off-balance sheet vehicles, and counterparty risk); adoption of a leverage ratio as a measure supplementary to the solvency ratio; and introduction of a liquidity standard, including a short-term liquidity coverage ratio and a long-term structural liquidity ratio.

The microprudential supervision of most Spanish banks, in line with those of other euro area economies, is now integrated into the ECB's functions. Additionally, as is also the case in other advanced economies, macroprudential supervision has been introduced, providing it with new instruments. The main aim is identifying possible systemic risk early and applying the measures required to prevent it from developing further and to mitigate its adverse effects on real activity in the event it materialises. In Spain macroprudential supervision corresponds to the different sectoral supervisors, such as the Banco de España in the case of banks, and is coordinated by a newly created body (AMCESFI) on which the Ministry of Economic Affairs and Digital Transformation and the different sectoral supervisors have a seat.

After this brief summary of the profound structural changes to the Spanish financial sector, I will now assess the impact of the COVID-19 crisis on the sector and the significant challenges for the medium term that it should already have tackled before the crisis broke.

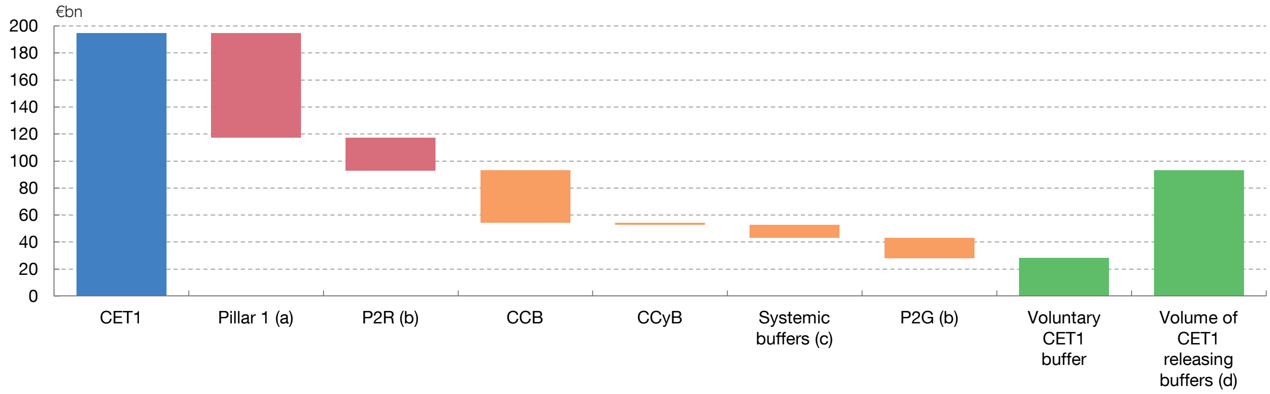
As I discussed earlier, banks now have greater solvency levels than in the previous crisis. This should help them play an active and leading role in the current crisis. Also, in order for the financial system to be able to contribute to overcoming the crisis, different decisions have been made at national and European level to help the banking sector better resist the onslaught of the crisis and operate as an active lever for its prompt recovery.

Thus, the different national and international authorities (in particular, the Banco de España, the ECB, the EBA and the Basel Committee) have issued different statements to clarify the impact of the existing accounting regulations on the current situation for an adequate calculation of credit risk impairment and to allow banks to make use of the capital buffers available to absorb unexpected losses.[65] On 28 April, the European Commission presented a raft of measures to encourage banks to make full use of the flexibility included in the EU's prudential and accounting framework.[66] This set of measures included an interpretative communication on the application of the accounting and prudential frameworks – a "quick fix" – to the Capital Requirements Regulation (CRR) approved by the Council and the Parliament in June. Among other measures, this amendment to the CRR establishes a mandate to the Commission, to be reported by 31 December 2021 to the Parliament and the Council, on the possibility of conferring additional powers for supervisors to impose restrictions on the distribution of dividends under exceptional circumstances. Also, the entry into force of the leverage ratio buffer requirement for global systemically important institutions under CRR II has been set back one year.

Chart 21

THE VOLUME OF CAPITAL EXCEEDING THE MINIMUM REQUIREMENTS CONSTITUTES A BUFFER TO ABSORB UNEXPECTED LOSSES

VOLUME OF CAPITAL EXCEEDING THE MINIMUM REQUIREMENTS
December 2019



SOURCE: Banco de España.

a Including all CET1 earmarked for compliance with the Pillar 1 Requirements, both the 4.5% required directly and that required from institutions with insufficient AT1 and T2 to meet their respective requirements of 1.5% and 2%.
b P2R refers to Pillar 2 Requirements, while P2G refers to Pillar 2 Guidance. Supervisory guidance in response to COVID-19 allows for the release of the P2G buffer and eases the rules on the composition of P2R, lowering the weight of CET1.
c Including both the G-SII and O-SII buffers.
d Under the supervisory guidance in response to COVID-19, releasable capital includes the voluntary CET1 buffer, the CCB, the CCyB, the systemic buffers and the P2G buffer.

65 Banks are allowed to operate temporarily below the levels defined by the Pillar 2 Guidance (P2G), the capital conservation buffer (CCoB) and the liquidity coverage ratio. As regards the composition of capital, the possibility of meeting the P2R with capital other than CET1 capital is also provided for.

66 See *Coronavirus response: Banking Package to facilitate bank lending- Supporting households and businesses in the EU*.

Precisely, in terms of capital buffers (the amount of capital exceeding the minimum regulatory requirement of Pillar 1 (7%) and the Pillar 2 requirement (P2R)), Spanish banks' CET1 amounted to somewhat more than €90 billion in December 2019. This amount could cover losses equal to nearly twice the current stock of non-performing loans, i.e. approximately 8.2% of total loans to the resident private sector.

Lastly, the temporary suspension of the distribution of dividends and the exercise of prudence in the payment of employee bonuses have been recommended to banks with the aim of channelling the funds generated towards strengthening their capital positions. The resolution authorities have also stated that they will take a forward-looking approach in the supervision of the minimum requirement for own funds and eligible liabilities (MREL), taking into account the specific nature of this crisis. The Banco de España has extended all of these measures to the institutions under its direct supervision.

Additionally, the monetary policy decisions adopted by the ECB from the onset of the crisis have contributed to reducing pressure on the financing conditions of banks and other public and private economic agents, in a setting of high uncertainty and widespread increasing financing needs.[67]

For its part, the Government approved in March a public guarantee programme for loans to firms, which has mitigated the possible reluctance of financial intermediaries to incur greater risks, against a backdrop of high uncertainty and growing concern for credit risk.

These measures appear to have been effective in smoothing the flow of credit to the economy in recent months. Thus, the latest data, for April, evidence a year-on-year increase of nearly 90% in the flow of fresh credit granted by banks to firms. This includes both new lending, the volume of which has doubled from the same period last year, and increases in drawdowns on the principal of lending transactions formalised previously. As regards lending formalised under the public guarantee programme, on the data published to 14 June, the guarantees requested totalled almost €52.8 billion. This has enabled slightly more than €69 billion to be mobilised through new loans and other funding facilities, of which almost €48.8 billion has been granted to SMEs and the self-employed. As regards moratoria on repayments of loans to households, 980,000 loans have been approved, involving a credit volume of approximately €36,300 million, 5.5% of the consumer credit and mortgage portfolios.

In any event, as regards the remaining measures relating to the provision of liquidity to firms, consideration should be given – once the current guarantee programme finalises – to ensuring that firms continue to have access to liquidity in order to facilitate their financing

67 In particular, the ECB has approved new targeted longer-term refinancing operations (LTRO, TLTRO-III and PELTRO) on very favourable terms. It has also extended the volume of purchases of securities under the asset purchase programme (APP) and has launched a new programme (PEPP), under which it will purchase public and private sector securities with an envelope of €1.35 trillion until at least June 2021.

when the recovery commences. The same is applicable to the other public support measures during the crisis. Indeed, although the evidence analysed by the Banco de España shows that bigger firms and those with a lower risk profile are obtaining financing on favourable conditions without resorting to the ICO guarantee facilities, smaller firms and those most affected by the crisis might encounter more difficulties gaining access to financing, especially in the absence of public support instruments.[68] In turn, it is necessary to gradually restore incentives so that financial resources are reallocated to firms and sectors that can most contribute to the recovery of activity and employment. All of this, accordingly, advises assessing the possibility of having available public guarantee mechanisms additional to those already approved. Their design should prioritise access to such funds for agents with sound prospects of viability once the current critical phase is over.

Also, the scale of the negative impact this crisis will have on activity will foreseeably impair, with something of a lag, the quality of financial institutions' credit portfolios. This will reverse the trend followed by this variable in recent years. Business closures, widespread job losses and, broadly speaking, a decline in borrowers' income will impair their loan repayment ability. Although these effects will be partially cushioned by the measures approved during the crisis which I mentioned previously, increased NPL inflows can be expected, as well as complications in terms of the recovery of non-performing loans and the disposal of troubled assets for some time.

Losses materialising on credit portfolios will exert additional downward pressure on the banking sector's profitability. This in a setting in which the COVID-19 crisis has already led to an increase in the cost of capital for banks as a reflection of heightened investors' risk aversion, although part of it may be temporary. This has led the spread between the return on equity and the cost of capital to be even more negative. Also, the low interest rate environment, which will likely persist for longer than was envisaged prior to the COVID-19 crisis, will hamper the recovery of profitability through growth in net interest income. Therefore, additional efforts will be required to cut operating costs and achieve efficiency gains.

The magnitude of the challenge which this crisis entails for the banking sector can be appreciated in the main financial market indicators. Thus, the valuation of banks on the stock markets, not only in Spain but globally, was substantially more affected than that of companies in other sectors. At the same time, the financing conditions of banks in the debt securities markets have also tightened, as reflected by the increase in the credit risk premium, which has nevertheless partially reversed in recent weeks, after reaching very high levels in mid-March.

Likewise, the figures relating to the decline in GDP in 2020 in the macroeconomic scenarios I outlined earlier point to the largest economic contraction in recent history in Spain

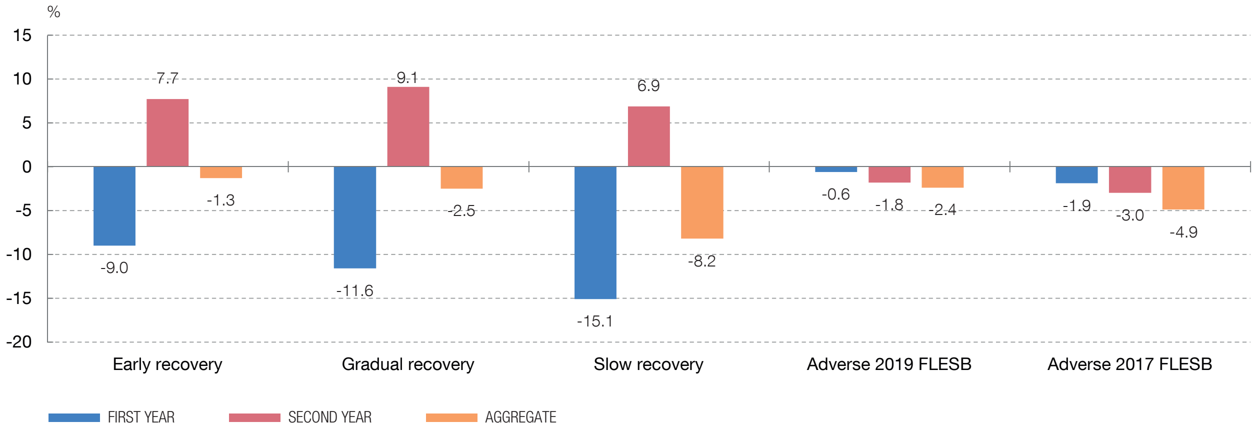
68 See R. Blanco, Á. Menéndez and M. Mulino (2020), *Spanish non-financial corporations' liquidity needs and solvency after the COVID-19 shock,* Occasional Paper No 2020, Banco de España.

in a single year. In terms of severity they also exceed the assumption of any stress test in the banking sector conducted in the past. In addition, underlying the foregoing considerations on the system's aggregate situation there is high heterogeneity. Thus, the crisis will affect different banks in different ways, depending on their business model and the distribution of their exposures to the sectors and territories most affected by the pandemic.

Chart 22

THE DECLINE IN GDP IN 2020 WILL BE STEEPER THAN THAT ASSUMED IN THE LATEST STRESS TESTS

RATE OF CHANGE IN GDP IN VARIOUS PROJECTED SCENARIOS

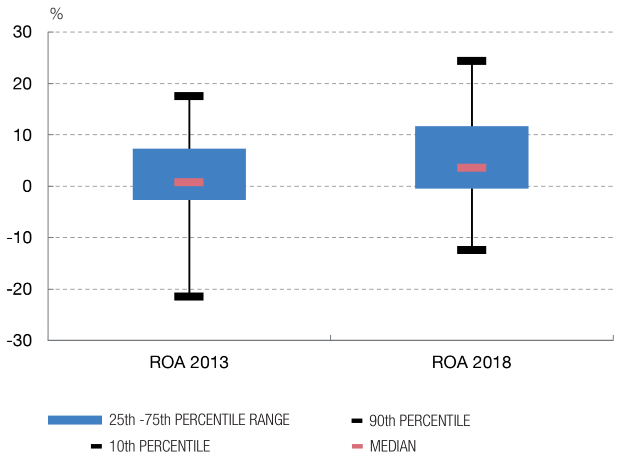


SOURCE: Banco de España.

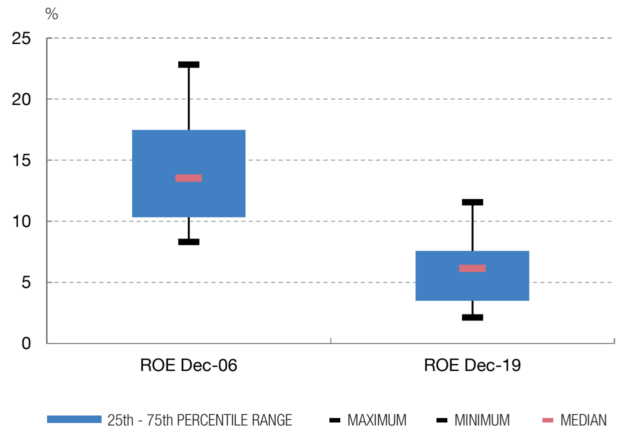
Chart 23

THERE IS MARKED UNEVENNESS ACROSS THE STARTING POSITION OF HOUSEHOLDS, FIRMS AND FINANCIAL INSTITUTIONS

1 NON-FINANCIAL CORPORATIONS: DISTRIBUTION OF RETURN ON ASSETS (ROA)



2 DEPOSIT INSTITUTIONS: DISTRIBUTION OF RETURN ON EQUITY (ROE)



SOURCE: Banco de España.

Conversely, it is also true that should the upturn in activity projected under the scenarios published both by the Banco de España and by other institutions materialise, the sharp fall in GDP in 2020 would be mitigated. In any event, there is a very high degree of uncertainty over the duration of the pandemic. In short, the materialisation of some risk factors overshadowing the Spanish economy's projected recovery could significantly undermine aggregate solvency, obliging us as supervisors to closely monitor the risks to financial stability. Even in these most adverse scenarios, loss-absorbing items make a non-immediate erosion of capital possible. This provides scope for action, which must be used to make use of all the items that will make an unequivocal, Europe-wide economic policy response possible.

As I noted in my previous testimony, I believe it is important for us to take as a starting point the experience of the past, both in this area and in others. And this experience should lead us to do everything possible to prevent the current situation from having a significant financial component. As we witnessed then, crises that have such a component are also characterised by being deeper and longer-lasting. I thus think our shared aim should be to prevent the crisis from being accompanied by a generalised tightening of financing conditions or from seriously damaging our financial system.

Aside from macroeconomic factors, legal risk and certain other items relating to banks' conduct have had a significant impact on the reputation of the banking sector in recent years, and not only in Spain. It is important to note here that reputation and customer confidence are fundamental to the banking business. Accordingly, banks should strive to reverse this tendency by providing their customers with financial products and services tailored to their needs and capabilities, as well as furnishing them with the relevant information clearly and transparently. In this connection, the important role banks are called on to perform in the current crisis – namely to provide adequate financing to households and firms – is a good opportunity to improve society's confidence in the sector.

In addition, as I noted earlier, impairment losses on credit exposures will take place later on, eroding institutions' capital levels and reducing their capacity to continue financing the economy. It is therefore crucial that the capital buffers built up by institutions can be used and that the public measures to support credit do not disappear abruptly, so that banks do not undertake a process of balance sheet reduction before the effects of the crisis have dissipated. For this purpose, institutions must have the certainty that capital buffers will be rebuilt very gradually and only ever so once the crisis has been overcome and financial markets have returned to a situation of relative normality. Some of the lessons learned during this crisis must be drawn on in the reconstruction of solvency levels, including greater emphasis on cyclical components that are releasable during macrofinancial crises, as is currently the case.

The health crisis has also brought into even sharper relief the urgent need to address certain challenges, such as those associated with digitalisation and cybersecurity risk management. The spread of the pandemic, and the resulting lockdown, have accelerated the activation of remote working protocols and business continuity contingency plans. This underscores the importance of pressing forward with the sector's digitalisation, seeking greater efficiency in the provision of financial services. This process will entail an increase in cybersecurity risk, which institutions will have to manage in order to minimise any adverse impact on their business activities.

In the medium term, further vigilance is required to ensure that the foreseeable continuation of the low interest rate environment does not lead to excessive risk-taking by financial intermediaries. Although the outbreak of the COVID-19 crisis prompted a pursuit of safe and liquid assets globally, over time, and once risk-aversion wanes, some investors may once again increase their risk-bearing asset exposures. Should such risk-taking, which is necessary for the smooth functioning of any economy, become excessive, financial systems may become more vulnerable to adverse shocks. To rein in any potentially destabilising dynamics, macroprudential authorities must broaden their range of available instruments, particularly in connection with the markets and non-banking intermediaries, where the least headway has been made to date.

In the medium term, the Spanish financial system, like those of other European economies, must also address the challenges associated with digital disruption and climate change. BigTech firms, with their capacity to collect, store and analyse vast volumes of data, could potentially begin providing services as financial intermediaries. This may significantly change the sector's traditional business model. In order to compete with BigTech firms, existing financial institutions will need to invest in new technologies and data processing methods. The financial sector must also play a leading role in the transition to a more sustainable and greener economy, providing the required volume of funding to carry out the structural transformation of the economy and including climate and environmental factors in their risk analyses. The challenges which climate change entails for the world economy and society in general, and for the financial sector in particular, will be the subject of the next section of my speech.

At the same time, the financial sector must also face the challenges associated with population ageing, which has important implications in terms of households' demand for financial services. First, demographic ageing will tend to reduce the demand for credit, given that households' financing needs are largest during the middle stages of the life-cycle. Second, these demographic developments will generate growing demand for new long-term savings and other products that make the wealth accumulated by individuals during their working life to cover living expenses in later life more liquid.

In short, given the extraordinarily prominent role the banking sector plays in the Spanish economy, how successfully these challenges are resolved will notably influence the intensity and sustainability of Spain's economic growth in the coming years.

Before ending this section, I would like to highlight the fact that, despite the progress made in recent years, which I have already discussed briefly, it is still possible to move forward in the design of a sounder financial architecture. I will devote the last section of my speech to discussing in detail some eminently European financial challenges. For example, those relating to the completion of a full-fledged Banking Union in the euro area. However, I would like to refer to certain domestic issues. In this connection, it is worth recalling that in 2017 the IMF issued, in the context of its Financial Sector Assessment Program (FSAP) exercise, some very specific recommendations for Spain regarding financial supervision.[69] In particular, among other actions, the IMF pointed to the need to set up a macroprudential authority, which has been done, but also to the importance of moving towards an integrated prudential supervision of the entire Spanish financial system. Also, against the backdrop of the current European debate on strengthening capabilities in combating money laundering and terrorist financing, we should address what institutional representation should be in place in Spain to deal with these criminal activities. Indeed, such activities precisely try to take advantage of the supervision fissures which might appear between jurisdictions, sectors or spheres of competence.

It is true that this is not the best time to set in motion financial architecture measures affecting the organisation and powers of the supervisors that are assessing and mitigating in real time potential risks to financial stability. However, I do believe that it is important to strengthen the commitment to addressing these issues promptly and ambitiously, once the crisis has been overcome. In this connection, we should not underestimate the fact that an optimal design of the national supervisory architecture may provide the Spanish economy with greater resilience to future crises and more influence in the related European supervisory and financial regulation bodies and mechanisms.

69 See IMF (2017), *Spain: Financial System Stability Assessment,* October.

9. Addressing the new structural challenges after COVID-19

All the challenges that I have mentioned so far are ones that, one way or another, the Spanish economy already needed to address before the outbreak of the COVID-19 pandemic. Indeed, as I have said, many of them are unresolved tasks for which a fully satisfactory solution has not been provided in over a decade. The current crisis may have increased the scale of these challenges, their visibility and the urgency to find a solution. But all of them were and are relatively well-known.

Yet the current crisis has also revealed some vulnerabilities that were not so evident and has triggered some major changes in agents' behaviour patterns, such as in household consumption habits and the organisation of work within firms. How these new vulnerabilities are tackled and how permanent or temporary the changes recently observed in agents' behaviour will ultimately be could have very significant implications for economic activity in the medium and long term, not just for Spain but globally.

I would now like to focus on those potentially structural shifts that the current health crisis could trigger in two processes that are key to the global economy: the globalisation of production and digitalisation.

The globalisation of production

I will start with COVID-19's potential implications for globalisation. Over recent decades, the growth of world trade has been accompanied by a growing international fragmentation of production processes. Broadly speaking, against the background of a favourable regulatory environment, firms have tended to relocate some of their production to other countries and to procure inputs from international markets, pursuing cost savings and efficiency gains. Thus arose the so-called global value chains (GVCs), which currently represent almost half of all global trade.[70] At the same time, in order to fully harness different economies' asymmetries in the pattern of productive specialisation, the production of certain final goods has been significantly delocalised, and in some cases concentrated in a few international suppliers. By way of a topical example, just seven countries produce 70% of the world's ventilators.

The COVID-19 crisis has highlighted some of the vulnerabilities associated with globalisation. For example, there have been major disruptions to global supply chains. These have placed constraints on production in sectors such as the car industry, one of great importance for the Spanish and European economies. In many countries, too, there have been major shortcomings in meeting minimal levels of domestic demand in the case of specific essential consumer and health-equipment goods.

Assessing, at this point in time, how the authorities and economic agents worldwide will react to these developments is particularly complicated. Considerable uncertainty

70 See *WDR Report 2020*, World Bank.

surrounds not only the type of response that will be provided globally to these vulnerabilities, but also whether it will be temporary or permanent.

In this regard, partly due to the re-emergence of protectionist trends in some of the major world economies, globalisation had already somewhat slowed in recent years. It would be of no surprise were this slowdown to steepen in the coming years as some countries seek to reduce their dependence on imported inputs and final goods and to boost domestic industry in specific strategic sectors. Indeed, some countries have already imposed restrictions, which could become permanent, on the export of some essential products. Likewise, albeit at the expense of some loss of efficiency, it cannot be ruled out that firms might opt to switch some phases of production to the parent company or to closer locations, to procure more from the domestic market, to diversify their sources of inputs and to build up more inventories to head off supply-chain risks.

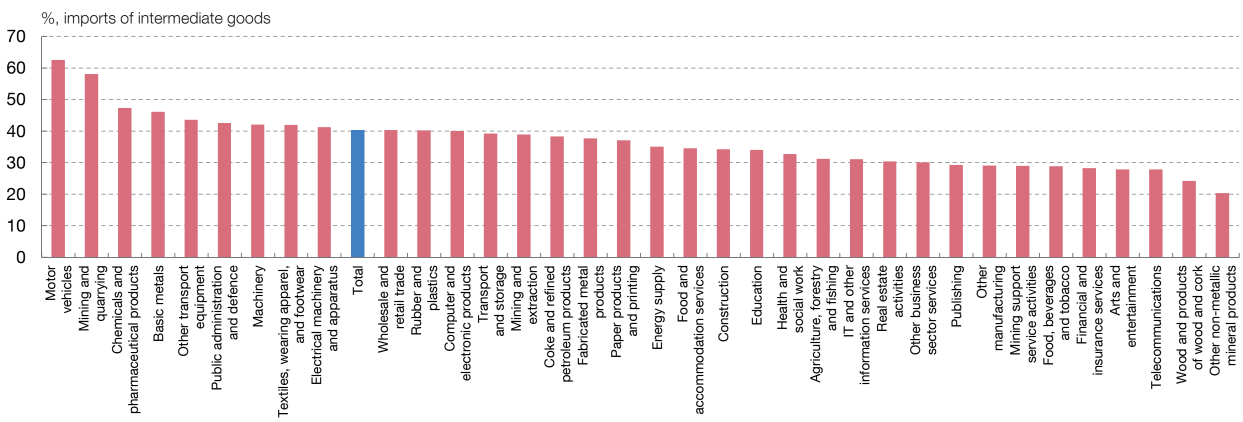
From an economic-theory and historical-evidence standpoint, there can be little doubt as to the clearly positive impact that international trade has on the level of activity and welfare globally. Accordingly, Spain should, to the extent possible, hold back from adopting protectionist strategies that might jeopardise the successful internationalisation process undertaken in recent years. For instance, since the global financial crisis, the weight of Spanish exports in GDP has increased by approximately 10 pp. This has undoubtedly made a marked contribution to supporting Spain's economic growth.

At the same time, we must acknowledge that this greater exposure to international trade renders us relatively more sensitive to a hypothetical situation in which trade flows were to slow strongly or global value chains were to diminish sharply. Faced with this possible

Chart 24

A POTENTIAL REVERSAL OF THE GLOBALISATION PROCESS WOULD HAVE AN ASYMMETRIC CROSS-SECTORAL IMPACT ON THE SPANISH ECONOMY

IMPORTED INTERMEDIATE INPUTS USED FOR EXPORTS, BY INDUSTRY-ORIGIN OF IMPORTS



SOURCE: OECD. Trade in Value Added (TiVA). 2015 data.

adverse scenario, it would be desirable for the Spanish economy to lead, in Europe and internationally, the defence of a global trade model based on free competition and a level playing field.

In any event, it would also be advisable for Spain to plan beforehand a strategy that would enable us to contend with potential adverse developments on this front. Such a scenario would probably have a very uneven cross-sectoral impact, since there are major differences as regards export orientation, participation in global value chains and import content. The most exposed sectors would undoubtedly include the automotive sector, which accounts for 12% of Spanish exports and is one of the sectors most integrated into international trade. Conversely, in the services sectors, business services and the hospitality sector – accounting for 5% and 6% of exports, respectively – have a relatively lower share in global value chains. Nevertheless, they will remain very sensitive to the faster or slower recovery in global demand following COVID-19.

Digitalisation

The COVID-19 crisis might also significantly alter the process of digitalisation in which economies and societies worldwide have been immersed in recent years. Internet-based connectivity between households, tiers of government and firms has undoubtedly been a key tool in recent months for lessening the impact of the lockdown measures adopted in most countries This has been particularly visible on three fronts: employment, where the resort to working from home has stepped up considerably; wholesale and retail trade and recreational activities, with the expansion of online channels; and education, where a shift from face-to-face to virtual classes has been possible in record time for millions of students whose schools and universities were shut down.

Naturally, some of these trends might prove to be permanent and even gain momentum in the medium term, especially those that may entail productivity gains or cost savings. True, it is currently very difficult to assess the potential intensity of this process and how adversely affected some sectors, firms or population groups could be by this transformation. But that should not be an impediment to initiating work on a strategy to position the Spanish economy on these fronts.

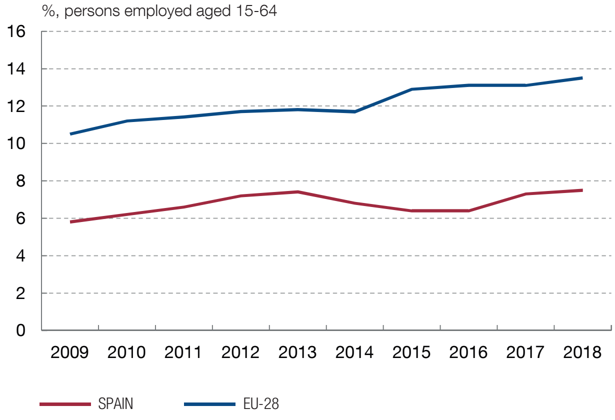
In this connection, allow me to provide a few brief considerations on working from home and e-commerce. The resort to working from home in Spain is still low compared with other European economies. For instance, while 13.5% of persons employed aged 15 to 64 teleworked in the EU-28 in 2018, this ratio was only 7.5% in Spain. There is, therefore, considerable potential for teleworking becoming more widespread in Spain. Specifically, a recent study by the Banco de España[71] suggests that, when factoring in each occupation's intrinsic characteristics, approximately 30% of the employed could telework, at least occasionally.

71 See B. Anghel, M. Cozzolino and A. Lacuesta (2020), "Teleworking in Spain", Analytical Articles, *Economic Bulletin,* 2/2020, Banco de España.

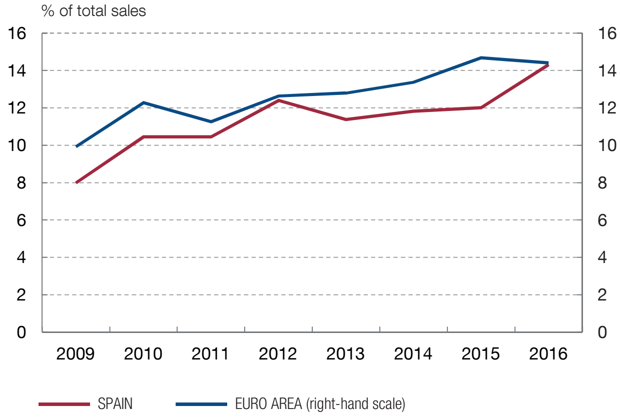
Chart 25

IN RECENT YEARS ONLINE TRADE AND WORKING FROM HOME HAVE INCREASED IN SPAIN, BUT THERE IS STILL ROOM FOR THE LATTER TO BE FURTHER IMPLEMENTED

1 TELEWORKERS IN SPAIN COMPARED WITH THE EU-28



2 ONLINE SALES IN SPAIN AND IN THE EURO AREA



SOURCES: Eurostat and Banco de España.

Yet the promotion of teleworking will need to bolster its positive aspects and seek to alleviate its potential disadvantages. In this regard, it is essential to bear in mind that the possibility of working from home and its potential impact on productivity will depend, among other aspects, on the type of work, on the firm's readiness to allow this activity to go ahead and on each employee's capacity to work remotely. As some studies have already evidenced, if conditions are unsuitable, teleworking-related productivity might be lower than that involving workplace attendance.[72] Furthermore, the findings of different surveys suggest that, although teleworkers usually view favourably not losing time on the home-work commute, greater schedule flexibility, a better work-life balance and better life control, some adverse effects on worker health have also been observed.[73]

It is also important to note that a potential implementation of working from home will have an asymmetrical impact on various groups of workers in the labour market. In particular, the aforementioned Banco de España study suggests that lesser-skilled workers and those linked to more basic activities would have greater difficulty benefiting from this mode of working. These asymmetries should therefore be taken into account when designing and implementing the active labour market policies I referred to when discussing the labour market challenges.

Another activity that has developed considerably in recent years, but particularly at the current juncture, is e-commerce. According to Eurostat, the share of sales via digital platforms in the euro area stood at around 14% in 2016, up by more than 4 pp since 2009. Spain has been party to this trend, as it has reached the same level as the euro area average.

72 See M. Morikawa (2020), *COVID-19, teleworking, and productivity*, VoxEU.org.

73 See A. I. Tavares (2017), "Telework and health effects review", *International Journal of Healthcare*, Vol. 3, No 2.

The growth in e-commerce in some segments during the lockdown continuing – or even gaining momentum – in the medium term cannot be ruled out. Hence, understanding the implications of this process in terms of business competition and price-setting dynamics will be key. However, the empirical evidence does not yet offer a conclusive response in this respect. Promptly identifying the potential winners and losers of this process and, if necessary, taking measures that minimise the potential adverse effects on the productive system or aggregate demand would also be necessary. In any event, as part of a comprehensive growth strategy it would be desirable to conduct the actions required to prevent this eminently global process from ultimately putting the Spanish economy at a competitive disadvantage (e.g. if we consider the high weight of SMEs in Spain). The starting point constitutes somewhat of a relative advantage, since, among other aspects, Spain enjoys one of Europe's best high-speed internet networks with 91% broadband coverage across the country.[74] Maintaining and, to the extent possible, strengthening this favourable starting position requires a collective effort from the Spanish economy and Spanish society to seize the opportunities that might arise on this front in the near future.

74 According to the National Commission on Markets and Competition (CNMC by its Spanish abbreviation), in 2018 the penetration of mobile communication and of mobile broadband in Spain stood at 116.1 lines and 98.6 lines per 100 inhabitants, respectively.

10. Boosting European governance reform

The Spanish economy's challenges cannot be understood or tackled from a purely national perspective. For one thing, some of these challenges are shared with the rest of the advanced economies, and the European countries in particular. For another, in a deeply interconnected world, national authorities' ability to act and the effectiveness of unilateral interventions are relatively limited. This is especially the case in the EU and in the euro area where, on many fronts, Europe is the optimal platform for taking action.

The nature of the current crisis warrants swift and forceful action by the EU to ensure economic recovery and to reaffirm the European project of social and economic progress. The health shock that triggered this crisis is exogenous in nature and unrelated to the greater or lesser structural or cyclical strength of the economies afflicted by it. Notwithstanding, its economic impact on Europe's various countries is particularly uneven. This is largely a result of each country's productive specialisation, itself a product of the workings of the single market. In this regard, protecting the single market also means preventing the pandemic from leading to excessive economic disparity among members.

Designing and appropriately applying the European recovery fund

Between April and May, the Council of the European Union approved significant crisis-management measures in the short term, which will no doubt help mitigate a portion of the crisis-related economic costs. Further, in the final week of May, the European Commission proposed a new temporary European budget for the 2021-2027 period. It is aimed at focusing on the financing of investment and reforms over a medium- to long-term horizon. If approved, this initiative would be a first step for the EU in playing a more significant role in the fiscal policy response over the course of the economic cycle. Such a strategy would enable the positive externalities arising from Member State-coordinated measures to be harnessed, as opposed to the implementation of a wide range of relatively uncoordinated national measures.[75]

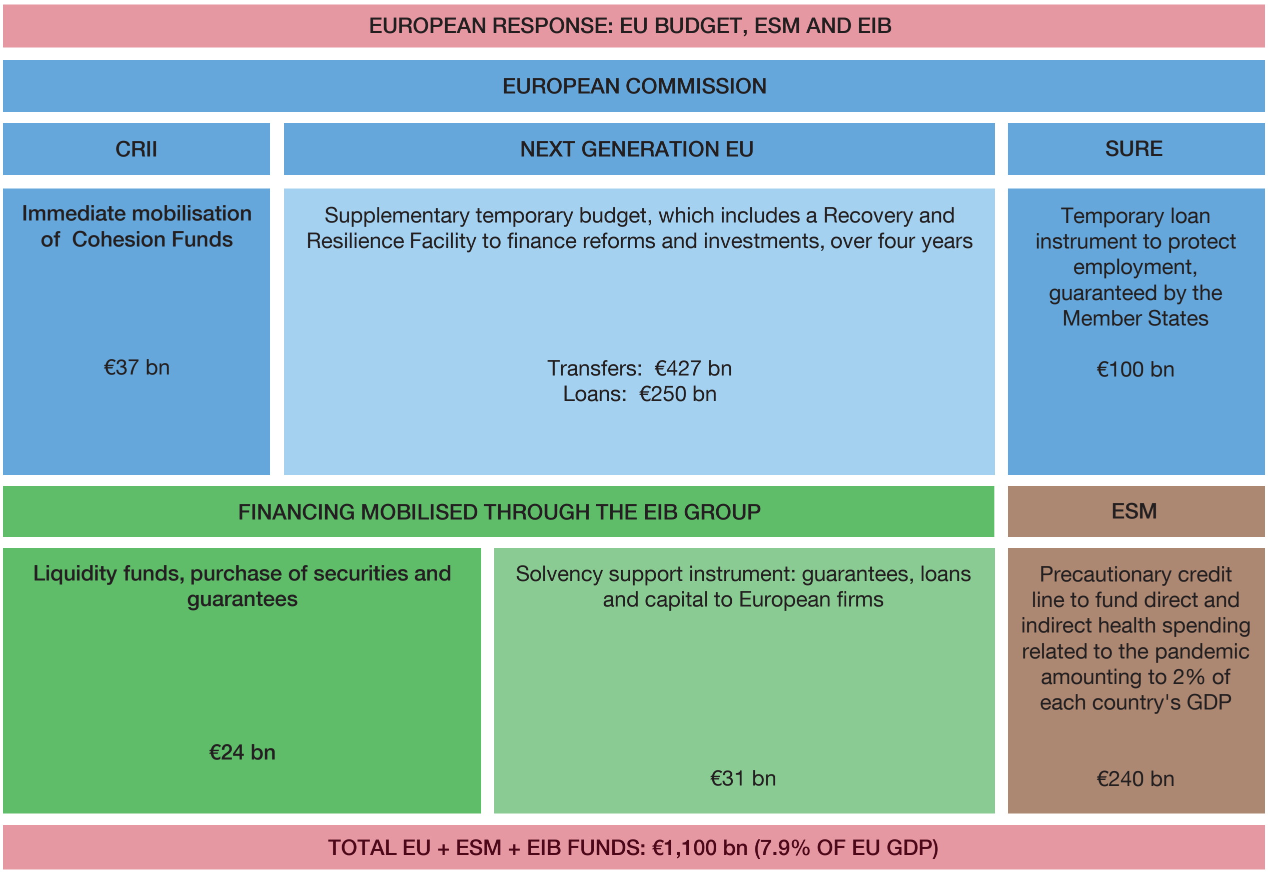
I shall examine some of the characteristics of this European fund and detail which elements may be susceptible to improvement. I will draw on different analyses prepared at the Banco de España and on some of the considerations that have arisen from the strictly academic discussion of these matters.

Firstly, from the standpoint of the financing of this fund, I consider it particularly timely to harness pooled debt capacity, through the EU budget, which is far greater than the sum of each individual Member State's debt-raising capacity. Moreover, this would be much bolstered in the current circumstances as a result of the historically low interest-rate environment.

75 See Ó. Arce, S. Hurtado and C. Thomas (2016), "Policy Spillovers and Synergies in a Monetary Union", *International Journal of Central Banking,* vol. 12, No 3, pp. 219-277.

Figure 1
THE EUROPEAN SUPRANATIONAL AUTHORITIES HAVE RESPONDED TO THIS CRISIS WITH NUMEROUS, ALBEIT STILL INSUFFICIENT, MEASURES

THE SUPRANATIONAL RESPONSE TO THE CORONAVIRUS CRISIS (a)



SOURCE: Banco de España, based on EU sources.

a The lightly-shaded parts are measures proposed by the Commission as part of Next Generation EU, pending approval.

As I have said, the benefits of joint debt issuance for the EU are not confined solely to the fiscal front, nor solely to the most indebted countries. Along with the saving in financial costs that could be had from the use of the Community budget for raising financial resources, the creation of a common safe asset would moreover help lessen the sovereign-bank nexus and would improve financial integration within the EU and, more specifically, within the euro area. It would also raise the capacity for diversifying risks within the EU; in the event of crisis, capital movements, which are usually routed to the safest references, might also be directed towards the common asset and not exclusively towards the sovereign debt of the higher-rated countries. Against a background in which euro-denominated safe assets are relatively scarce, the availability of this new safe asset would also provide incentives to international investment and would contribute to strengthening the international role of the euro.

Secondly, in terms of this fund's mandate, I believe it should be possible in the current crisis for its resources to be channelled both to national needs and to the financing of challenges common to all the EU countries. Naturally, the allocation of these resources would need to be accompanied by clear and transparent governance. This would include conditions such as those proposed by the European Commission, linked to the EU's strategic objectives and to the reinforcement of countries' growth capacity.

However, the current proposal focuses on the medium and long term. Overall, then, and even taking liquidity mechanisms such as SURE or the ESM-approved credit line into account, there continues to be a disconnect between the high financing needs of public spending related directly to the pandemic and the European funds made available to countries to finance it. To cover this gap, it would be advisable for the fund to be bigger and more nimble, being able to act swiftly without the delays inherent in the proposal, approval and launch of public investment projects.[76]

Thirdly, there is the matter of how the fund's resources should be assigned to the Member States. The allocation proposed, which includes a significant transfer component, would be a major step forward for the EU since it would mean that a portion of the cost of the recovery would be distributed among the EU members. In this connection, in any event, these transfers must be big enough and made available to the countries at times at which their economy is most fragile. If the approval of the European fund is excessively delayed and, later, the resources have to be released on the basis of the investment projects proposed, the ability to provide for risk-sharing at the current time of need would be diminished.

Progress in creating a Fiscal Union

Having a recovery fund of these characteristics, financed by European debt, would be a significant step. But beyond this, the crisis has shown that deepening the EU must irrevocably involve a greater weight of supranational systems, and the extension and greater flexibility of the EU budget. Insofar as the future challenges for the European economies will necessarily be shared ones, it would be reasonable for their financing to be shared. In this respect, increasing the Union's resources would have to involve the greater weight of European taxes. There are many alternatives. For instance, future taxes could be levied on the digital economy or on the most pollutant activities in order to decarbonise the economy. The fact that the tax base of these potential taxes can be switched from one country to another with relative ease would in itself warrant a high degree of pan-European coordination, at the very least.

In any event, and while we should not cease to be ambitious, the move towards a genuine fiscal union should no doubt be envisaged more as a medium-term objective than as an immediate priority. Nor should we forget that the European fund proposed is

76 See Ó. Arce, I. Kataryniuk, P. Marín and J. Pérez (2020), *Thoughts on the design of a European Recovery Fund*, Occasional Paper No 2014, Banco de España.

modest in size compared to the EU economy as a whole and is temporary in nature. Hence, in the short term, the momentum provided by recent agreements should be harnessed to also create new, permanent European instruments that allow for greater risk-sharing. Pan-European unemployment insurance complementing national insurance would be a natural candidate, ideally forged as something automatic (based on the individual entitlements of the workers affected) and permanent (and, therefore, predictable, and not linked to ad hoc political agreements).

Reforming the European Stability and Growth Pact

The European fiscal framework also needs a thorough overhaul to improve the design and coordination of national fiscal policies. It should be remembered that, in a monetary union, fiscal policy is the main instrument available to countries with which to tackle asymmetric shocks. Hence, beyond the creation of common macroeconomic stabilisation instruments for the fiscal area I referred to, it is crucial that each economy pursue a countercyclical fiscal policy that generates sufficient room for manoeuvre in expansionary phases to respond to adverse situations.

It was for this purpose that the SGP was designed. Complying with this framework of budgetary rules and procedures is also essential for the macroeconomic stability of the euro area. In effect, in the euro area the consequences of fiscal measures are each country's sole responsibility, which led to a no-bail-out clause being included, ruling out the possibility of one Member State's government debt being taken on by the area as a whole. The main purpose of this clause was for financial markets to play a role in imposing discipline by demanding different risk premia according to each country's domestic economic situation. However, at the same time, limits were set on government deficits and debt, backed up by the SGP, justified by the assumption that financial markets do not always act as a deterrent to inappropriate policies and that the no-bail-out clause might not be entirely credible. This is because one country's fiscal sustainability might have a negative impact on the others, causing strains on the Union as a whole that ultimately make it desirable for it to come to the aid of countries in difficulty.

This framework of fiscal rules is the result of a series of successive reforms aimed, in some cases, at ensuring fiscal policy's ability to respond to adverse shocks (such as the 2005 reform or the introduction of flexibility criteria in 2015) and, in other cases, at encouraging fiscal discipline (introduction of the spending rule and the sanctions rule, operating procedure for the debt criterion, etc.).[77] On top of this there is a series of agreements on how to interpret the existing rules. These generally seek to clarify points that have caused most tension between the European Commission and the Council and have been compiled in a document, the Vade Mecum on the SGP, whose 200-plus pages illustrate the complexity of this framework.

77 See P. Hernández de Cos (2014), "El nuevo marco de gobernanza fiscal europeo", *Papeles de Economía Española,* 141, pp. 66–83; and P. Hernández de Cos (2017), "Reglas e instituciones para la gobernanza fiscal en Europa", *Anuario del Euro 2017, Un futuro para la Unión Monetaria,* pp. 237–257, Fundación ICO.

Despite all these rules and procedures, the SGP has not succeeded in contributing to the design of countercyclical fiscal policies. Its excessive complexity, with rules that sometimes overlap and procedures that lend themselves to discretionality, results in its being somewhat opaque and difficult to communicate to the general public, which does not facilitate its implementation. This complexity also makes uneven application across countries and over time more likely, undermining its legitimacy and credibility. Hence the pressing need to overhaul the current fiscal framework.

There is broad consensus that the reform should be aimed at reducing the number of rules around a single objective – reducing debt – and an operating rule – the spending rule – so as to ensure that public spending does not exceed nominal long-term GDP growth and that it stays below it in countries with high levels of debt.[78] The advantage of a spending rule is that it exerts control over the variable which most often suffers deviations in budget outturn. It also discourages the extraordinary income often generated in expansionary periods from being used to finance permanent increases in expenditure, so such income can instead can be used to generate headroom to withstand adverse situations. Countering those who argue that this rule may hinder the fiscal policy response during severe crises that require expansionary measures, this framework could incorporate clear and transparent opt-out clauses to introduce the necessary flexibility in the event of severe shocks.

However, a system of rules alone cannot be expected to be sufficient to ensure the necessary radical shift in the design of European fiscal policies at country level. Available estimates drawing on the experience of countries that introduced spending rules before joining the euro area suggest that they only had a differential impact on those economies which already had institutional governance that was contributing to a more transparent debate on budgetary plans and their implications. In this regard, beyond the simplification of the fiscal framework, it would also be necessary to make headway towards more automatic implementation, so as to avoid excessively discretionary application. Also, this more automatic operation of the rule can be linked to the functioning of the independent national fiscal authorities or the European Fiscal Board. As a result, these institutions could have competence conferred on them to monitor and evaluate the degree of compliance with the rules and, when applicable, to trigger the automatic adjustment mechanisms.

Completing the Banking Union

European financial architecture reforms include most notably those relating to the completion of a full-fledged Banking Union in the euro area. The cornerstone pending approval for this Union is a fully pooled European Deposit Guarantee Scheme. It is well worth reiterating here that the financial channel, and the credit channel in particular, will be a means of risk-sharing among private agents in the European economy that complements and reinforces the public channels I mentioned earlier. Moreover, these private channels are particularly

78 See the proposal of the European Fiscal Board (2018), *Annual Report,* Brussels; and Z. Darvas, P. Martin and X. Ragot (2018), "European Fiscal Rules require a major overhaul", *Bruegel Policy Contribution,* 18.

important in episodes of deep-seated economic contraction, insofar as they mitigate the possibility of these episodes posing an element of financial instability that would but prolong and exacerbate the contraction.

In our opinion, the early announcement of a credible commitment to the full completion of the Banking Union, even were it to come about at a later date, would be a decisive contribution to ensuring euro area financial stability, both in the coming months and over a medium-term horizon.

Secondly, the EU Member States should move swiftly to reach an agreement on creating a common European procedure for the winding-up of credit institutions. This procedure could benefit from the instruments developed for the resolution of credit institutions, aimed at maximising the realisable value of the financial assets that make up the bulk of bank balance sheets. In Spain, recent experience shows the relative inefficiency in terms of time and recouped value of the current insolvency proceedings for credit institutions. Accordingly, it would be advisable to make headway in defining an administrative mechanism for the winding-up of credit institutions that maximises the preservation of value and reduces the timeframe and costs of the current insolvency proceedings.

Furthering the development of a Capital Markets Union

Progress is also needed in lowering the institutional and regulatory barriers standing in the way of a true Capital Markets Union in the region. And it is important to understand why this is necessary. Allow me to illustrate with a very specific case, of particular significance for the Spanish economy. I have mentioned today that one of the main challenges Spain must address is to close the gap in human and technological capital with our peer economies. To do this it is necessary to increase the amount of investment, public and private alike, in R&D&I. However, financing this type of activity is a challenge in itself. Not only because the attendant returns usually pose a bigger relative risk, but because the specific nature of the intangible assets generated with these investments hampers their use as collateral. The upshot is that debt is not the most suitable instrument for financing innovation and that innovative firms that exhaust their internal sources of funds usually resort to the capital markets and, more specifically, to venture capital to obtain the funds needed with which to pursue these activities. Hence the extraordinary relevance of the various initiatives of the EU in respect of the Capital Markets Union seeking to develop these markets. All the more so in the case of the Spanish economy which, as it is relatively highly banked and has a less developed venture capital industry than, for instance, the Anglo-Saxon countries, is at a disadvantage when it comes to funding R&D&I activities that boost our productivity growth.

Moving to a true Capital Markets Union in Europe firstly requires a clear and firm political commitment by the national authorities to this common project. Otherwise, as has occurred in the past, national interests defending domestic rules and structures will prevent the progress needed to improve the efficiency and integration of European capital markets. Attaining this objective will, secondly, call for a detailed and rigorous plan of measures that need to be implemented. Precisely with the aim of designing such a plan, the European Commission assembled a group of international experts in late 2019, the *High Level Forum on Capital Markets Union.*[79] The final report by this group, published this very month, should serve as a starting point to move resolutely towards the integration of European capital markets. In particular, this report sets out, in a relatively granular fashion and with a detailed calendar, 17 groups of closely related measures. These should be undertaken without delay to eliminate the main obstacles which, in recent decades, have prevented European financial institutions from increasing the scale of their operations, especially at the cross-border level; have lessened the attractiveness of European markets for international investors; and have restricted the ability of the region's financial institutions to compete globally. Broadly, the measures proposed seek various goals: to increase European citizens' confidence in capital markets; to simplify the current rules and address their unwanted effects; to reduce legal uncertainty (especially of cross-border operations); to improve access to information and reduce its cost; to encourage the use of digital technologies; and to review the obstacles to investment. As I have said, it will only be possible to further develop this plan if, from the outset, the national authorities show a degree of ambition and commitment that is up to the scale of the dysfunctionality that the current lack of integration of our financial markets entails for the European economy.

79 See *High Level Forum on Capital Markets Union* and *Final report of the High Level Forum on the Capital Markets Union - A new vision for Europe's capital markets*.

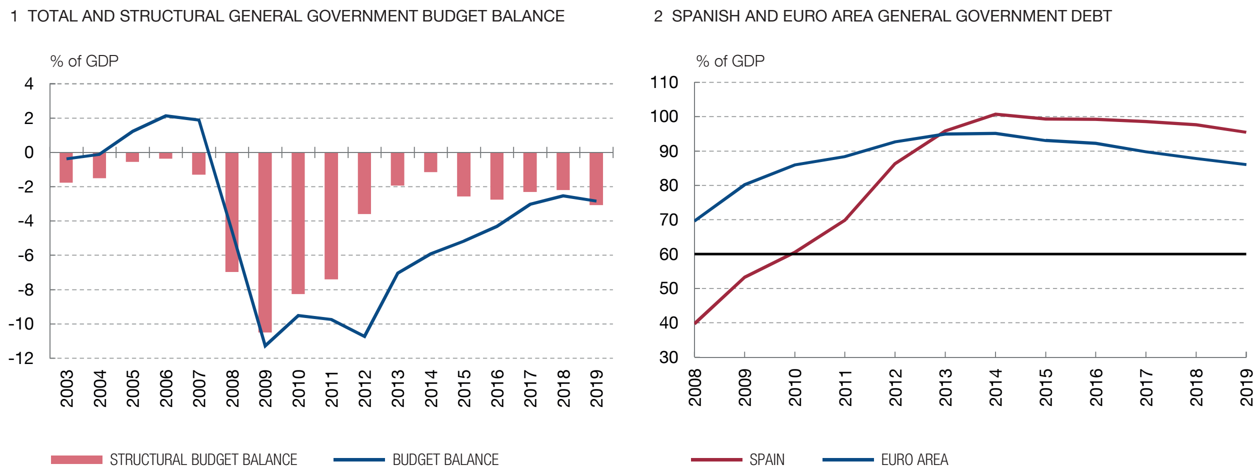
11. Ensuring public finances sustainability

The COVID-19 pandemic has dealt a blow to the Spanish economy at a time when the general government finances were still displaying some significant vulnerabilities.

Indeed, in recent years, despite vigorous and uninterrupted growth, the Spanish economy has not rebuilt its room for fiscal manoeuvre, which was considerably undermined in the wake of the prior crisis. In fact, following several years of declines, the overall general government deficit rose to 2.8% of GDP in 2019. In structural terms, i.e. discounting the effect of the economic cycle, the public finances shortfall also increased to above 3% of GDP in 2019, according to the Banco de España's estimates. Thus, no notable headway can be said to have been made in reducing the structural budget deficit since 2015, and any adjustment to the budget shortfall since then would have arisen solely because of the improvement in the economy's cyclical position and lower interest expenditure on debt.

Chart 26

DESPITE VIGOROUS GROWTH IN RECENT YEARS, THE SPANISH ECONOMY DID NOT REBUILD ITS ROOM FOR FISCAL MANOEUVRE



SOURCES: IGAE, Eurostat and Banco de España.

The government debt-to-GDP ratio stood at 95.5% at end-2019, just 5.2 pp below its 2014 peak and far higher than the 60% reference value under the prevailing European fiscal rules and the Organic Law on Budgetary Stability and Financial Sustainability.

These developments put the Spanish public finances in a weaker starting position than that of other European countries for dealing with the COVID-19 crisis.

In any event, as I have held previously, the economic policy response to this crisis requires, in the near term, resolute fiscal action. By supporting households' and firms' income in the short term, a swift and forceful fiscal response will help prevent a more persistent impairment of the economy's growth capacity and will foster a speedier and sounder economic recovery once the pandemic has been overcome.

Nevertheless, we must acknowledge that the fiscal measures adopted to mitigate the pandemic's effects, the inevitable macroeconomic downturn and the operation of the automatic stabilisers will all have a particularly adverse impact on the public finances. Specifically, the scenarios contained in the Banco de España's latest forecasts anticipate a very sizeable increase in the government deficit and debt in 2020. That would only moderate slightly in the following years as the temporary measures implemented to mitigate the COVID-19 crisis are rolled back and, at the same time, economic activity gradually recovers. Even so, in 2022 the general government deficit would still stand at very high levels, while debt would decline very slightly compared with estimates for that year.

Therefore, as in other European countries, after the pandemic we will encounter the highest level of government debt in many decades. The persistence over time of such high levels of government debt would reduce the countercyclical room for manoeuvre available to fiscal policy to address adverse macroeconomic shocks. It would also expose the Spanish economy to chronic vulnerability in the face of changes in investor sentiment on financial markets. Further, this high public debt would weigh down on the growth capacity of the economy, in that it would affect its aggregate financing conditions and distort private-sector investment decisions.

Therefore, while in the short term the response to the health crisis should be accompanied by resolute fiscal measures to soften its impact, in the medium term far-reaching reforms must be enacted to reduce public debt and ensure the sustainability of the public finances.

The scale of the public finances challenge is clearly highlighted when considering the possible developments in government debt over an extensive time span. Let us assume the gradual budgetary consolidation process is tied to the provisions of the SGP and take as our central premise that, once the effects of the crisis have dissipated, the structural deficit diminishes by 0.5% of GDP per year until a structural government balance in equilibrium is achieved. It can then be estimated that, under certain reasonable assumptions,[80] the general government debt-to-GDP ratio would tend to decrease gradually in any of the Banco de España's aforementioned scenarios. Specifically, under these assumptions, the general government debt-to-GDP ratio will decrease gradually over the period until falling below 100% at end-2030 in the gradual recovery scenario.

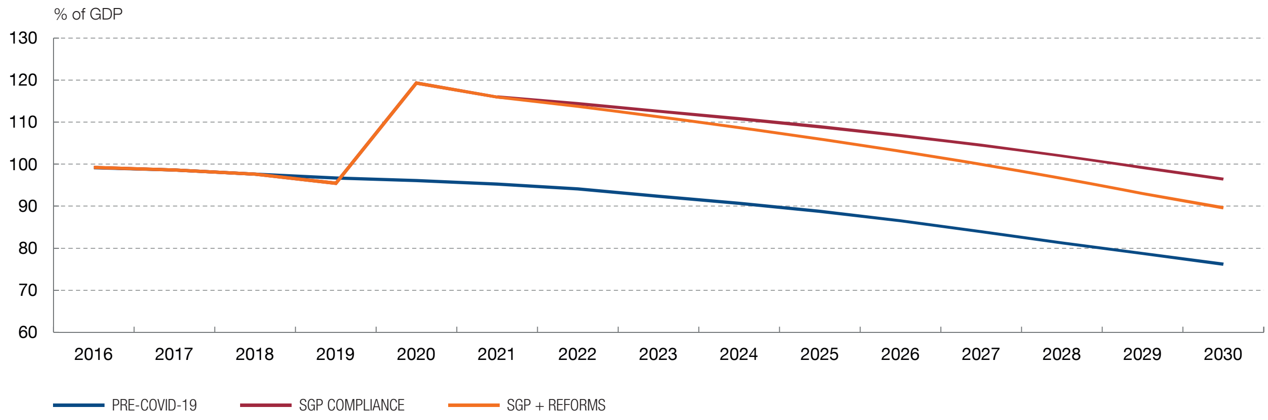
To bring general government debt back onto a path consistent with the fulfilment of the SGP commitments calls for an ambitious multi-year fiscal consolidation programme. The

80 Specifically, it is assumed that the potential growth of the economy is somewhat higher than 1%, that the GDP deflator converges towards 2% from the mid-2020s and that the average interest rates on debt increase only slightly compared with their current levels.

Chart 27

REDRESSING PUBLIC DEBT CALLS FOR AN AMBITIOUS MEDIUM-TERM FISCAL CONSOLIDATION PROGRAMME

SIMULATED PUBLIC DEBT PATHS UNDER THE GRADUAL RECOVERY SCENARIO USING CERTAIN ASSUMPTIONS



SOURCE: *Macroeconomic projections for the Spanish economy (2020-2022),* Banco de España.

programme should be part of a comprehensive growth strategy, aim to improve the quality of the public finances and encompass all tiers of government with power in this arena. It should be structured around a detailed definition of the budgetary objectives sought and the timeframes and measures required to achieve them. The adjustment programme should also be based on a prudent forecast of macroeconomic developments and include a rigorous early-response plan in the event of potential slippage from the objectives set.

It is not possible to withdraw prematurely the emergency fiscal measures in the near term, since this would increase the risk of economic growth enduring more lasting damage. Notwithstanding, announcing in advance a strategy for reducing fiscal imbalances to be implemented subsequently would have substantial benefits for the credibility of Spanish economic policy and would help boost the expansionary effects of the current fiscal policy measures.

The specific details of this necessary revision of the prevailing fiscal framework must of course be decided in the political realm, so that Spanish society's various preferences with regard to the level and composition of the government revenue and expenditure items are appropriately weighted. Yet, irrespective of the specific manner in which budgetary policy responds to Spanish society's fiscal preferences, there are several fundamental components that, in our opinion, should be part of any fiscal consolidation strategy. I will discuss those next.

Naturally, the fiscal adjustment process will inevitably require the level of government spending in Spain to be brought into line with the level of government receipts, or vice versa. This is an important nuance: we can opt to reduce spending, increase receipts or a combination of the two; but, over a longer time frame, they must be squared.

Furthermore, the composition of the adjustment between receipts and expenditure is key to minimising the adverse effects of fiscal consolidation on economic growth. As in many other areas of economic policy, there is no universally accepted blueprint for an optimal composition of public expenditure and revenue. Yet cross-country comparisons with those economies that are most relevant to us – those with which we share a more similar economic structure, the same markets and even, in the case of the euro area, the same currency – offer, in our opinion, a useful starting point.

On the expenditure side, several considerations should be made that could influence future spending developments. They also illustrate the challenge facing us. First, the anticipated rise in government debt as a result of the current crisis will also trigger an increase in the interest burden. The pandemic will further likely lead to greater structural demand for basic welfare expenditure, such as on healthcare. Such expenditure, together with that associated with caring for the elderly and, especially, spending on pensions, will likewise undergo upward pressure as a result of population ageing, particularly if application of the pension revaluation index is suspended definitively and the sustainability factor is eliminated. I will discuss this matter in greater detail later. Furthermore, the recent approval of the minimum income scheme entails an increase in permanent expenditure, officially estimated at around €3 billion per year.

Lastly, as I reiterated earlier, investment in human and technological capital is one of the main drivers of an economy's productivity and long-term growth capacity.[81] Yet in Spain, government investment in these items is low. It would therefore seem desirable to preserve the funds earmarked for these budget items. Climate change and the transition to a more sustainable economy will also have a substantial impact on some expenditure.[82]

Set against the need to correct budgetary slippage, performing an in-depth review of the various budget expenditure lines becomes a priority. The aim here is to identify those areas in which there is room for greater efficiency, as the Independent Authority for Fiscal Responsibility (AIReF by its Spanish abbreviation) has been doing in recent years.

As I stressed in my introduction, this thorough analysis of the efficiency of government expenditure must be part of a strategy for the ongoing and detailed assessment of government policies. In this respect, the conclusions of the first phase of AIReF's public spending review last year highlight the presence of ample room for improvement in key expenditure components such as those on pharmaceuticals, subsidies and active labour market policies. It is important that AIReF's previous recommendations, along with those stemming from the review currently under way, be taken into account as soon as possible in the budgetary process.

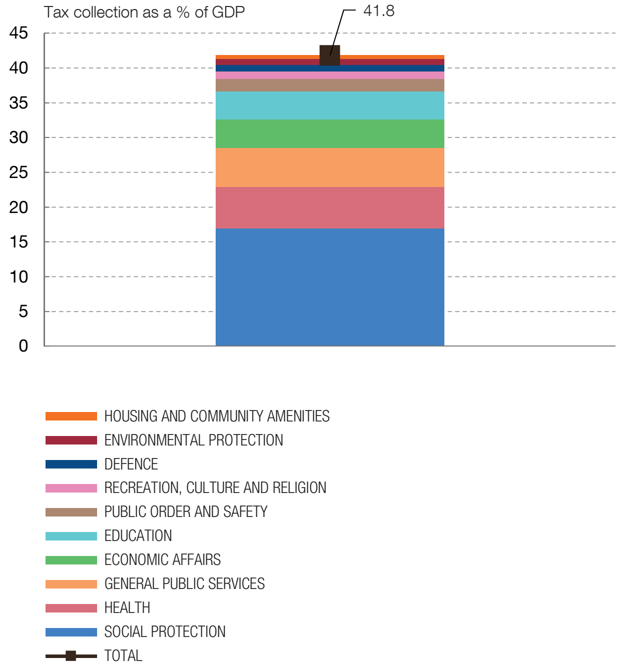
81 See, among others, J. Fournier (2016), *The Positive Effect of Public Investment on Potential Growth*, OECD Economics Department Working Papers, No. 1347, OECD Publishing, Paris; and European Commission (2017), *Government investment in the EU: the role of institutional factors, Report on Public Finances in EMU 2017,* pp.133-186.

82 The European Commission estimates, for example, that attaining the EU's climate targets by 2030 will necessitate additional annual investment by the public and private sector equal to 1.5% of Europe's GDP. See European Commission (2019), The European Green Deal: Questions & Answers.

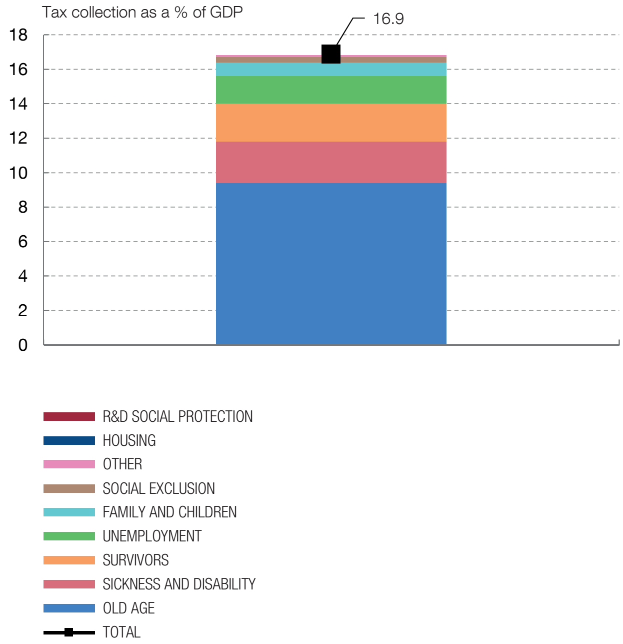
Chart 28

AN IN-DEPTH REVIEW OF ALL GOVERNMENT EXPENDITURE LINES AND INCREASING THEIR EFFECTIVENESS WILL BE NECESSARY

1 TOTAL EXPENDITURE



2 EXPENDITURE ON SOCIAL PROTECTION



SOURCE: Eurostat.

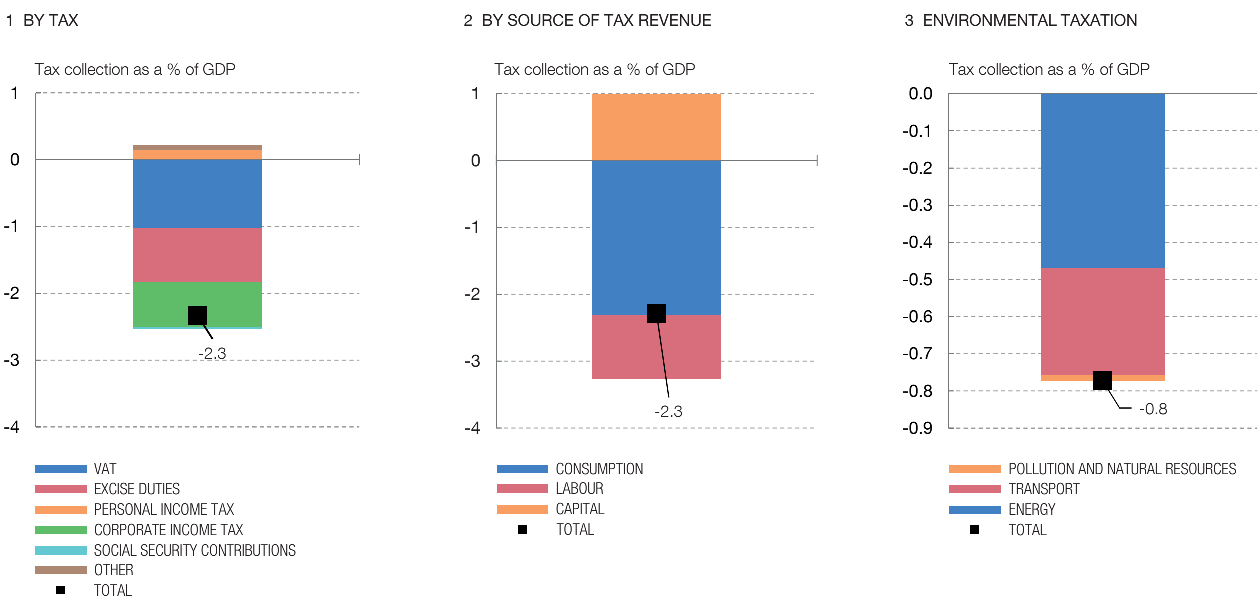
On the revenue side, tax revenue in Spain, including that relating to social security contributions, is around 2 pp lower than the euro area average.[83] About 40% of this difference is due to lower VAT takings in Spain, given the high percentage of consumer goods bearing a reduced or super-reduced rate. Revenue arising on corporate income tax and excise duties each account for around 30% of the difference. In the case of the latter, environmental taxation plays a prominent role; the revenue gap between average euro area and Spanish tax collection is 0.8 pp of GDP, mainly as a result of the low taxation of oil and gas and of transport in Spain. Lastly, personal income tax and social security contributions do not contribute significantly to the revenue gap with the euro area, although it is true that employers' social security contributions in Spain are higher than the European average.

In a broader context, one distinctive feature of Spanish taxation susceptible to reconsideration is the high level of tax benefits. These benefits, derived from the presence of numerous exemptions, deductions and special reduced rates, give rise to significant

83 In this regard, if we use the tax-to-GDP ratio as a benchmark, in 2018 (the last year for which comparable tax information is available for the euro area countries) this ratio stood at approximately 35% in Spain, around 6 pp below the euro area's level. This difference decreases to around 2 pp when the arithmetic mean of the various countries is considered. For a detailed description of the structure of the Spanish tax system compared with that of other EU economies, see D. López-Rodríguez and C. García Ciria (2018), *Spain's tax structure in the context of the European Union*, Occasional Paper No 1810, Banco de España.

Chart 29
TAX COLLECTION IN SPAIN IS LOWER THAN THE EURO AREA AVERAGE

DIFFERENCES BETWEEN THE COMPONENTS OF TAX REVENUE IN SPAIN AND THE EURO AREA-19 AVERAGE IN 2018



SOURCE: Eurostat (2017 and 2020).

forgone revenue and distort the efficiency and fairness of the tax system. The findings of the second phase of the ongoing review of public spending by AIReF, which explicitly includes the analysis of tax benefits,[84] will make a significant contribution to this much-needed comprehensive review of the efficiency of the tax system.

Currently in passage through Parliament is the draft legislation for the introduction of two new taxes, falling respectively on certain financial transactions and on the provision of digital services. The revenue-raising capacity of these or other new taxes will be influenced, among other factors, by the degree of fiscal coordination in these areas internationally. In particular, the Spanish economy's high degree of international integration, against a background in which certain tax bases can shift with relative ease across jurisdictions, suggests the advisability of attaining some degree of coordination with other countries in introducing certain taxes. The aim here is to prevent the emergence of competitive disadvantages and the delocalisation of certain tasks, with the subsequent adverse impact on economic activity pursued in Spain and, therefore, on tax revenue.

In the case of the new tax on the provision of digital services, the OECD-sponsored negotiations currently under way internationally should, as reflected in the draft legislation,

84 On 14 December 2018, the Council of Ministers entrusted to AIReF the second phase of the public spending review, focused on analysing tax benefits and hospital spending (forthcoming).

serve to set minimum common conditions for the future orderly introduction of this tax. This will be so at least in the main advanced economies, with transposition to Spanish legislation once the conditions are approved. This international coordination drive is also significant with a view to other taxation tools that may affect other areas, such as environmental taxes or those on the activities of certain multinationals.

For fairness and efficiency reasons, combating tax evasion must also be part of any tax strategy.

Lastly, it is important to stress that, in an administrative structure as decentralised as Spain's, in which territorial governments are responsible for more than 40% of government expenditure, their involvement in the fiscal consolidation drive is essential to improving the efficiency of government spending and, in short, to ensuring fiscal stability. There is a broad consensus on the need to reform the system of territorial government financing, tailoring the resources, based on a previous objective estimate of reform requirements, in order to ensure a transparent distribution of funds and increase the degree of fiscal co-responsibility.

12. Conclusions

I shall conclude by underscoring the five attributes for the growth strategy which Spain, in my view, currently needs: it should be urgent, ambitious, comprehensive, assessable and based on broad consensus.

Urgent, owing to the extraordinarily complex circumstances the Spanish economy will face in the coming months and to the scale of the challenges to be tackled once the pandemic is behind us. It is important to bear in mind that inaction works against us, since a lack of response to these challenges raises the scale of the threat. I thus insist that our economy urgently needs a growth strategy.

Ambitious, because the complexity of the situation and the scale of the challenges that will mark our future in the coming decades require a broad raft of – in many cases disruptive – reforms, not minor, isolated adjustments.

Comprehensive, because the challenges conditioning the economy's growth outlook and the well-being of our society are closely interrelated. Seeking to resolve any of them in isolation is neither feasible nor desirable. We thus need a well-planned strategy in which the multi-faceted impact that each economic policy decision may have is assessed, and which seeks to strike a balance between different objectives that are not always simultaneously compatible.

Moreover, the strategy should be regularly assessed to identify areas where its design or application may be improved.

It must be based on broad consensus, to infuse it with permanence and credibility. Structural challenges call for structural responses, that last over time. Therefore, in a democratic society like ours, the guiding principles of this strategy should enjoy a high degree of consensus across the various political, economic and social agents. In that way the foundations underpinning growth may be stable and not subject to the vicissitudes of the political cycle.

Furthermore, the strategy should combine medium- and long-term priorities with other, more pressing needs linked to the consequences wreaked by the pandemic (and which will last some time longer) on the weakest links in our economy and society. Until the significant uncertainty shrouding the recovery of the global, European and Spanish economy is dispelled, we will need to maintain many of the measures introduced in recent months. These will have to be duly adapted to the economic situation, which is expected to evolve unevenly across productive sectors and among economic agents. As a recovery path takes hold, the time will come when the temporary measures may be rolled back, giving way to other, very different measures whose common denominator will be to smooth the adaptation of our economy to the new post-pandemic scenario that will emerge.

Finally, we should bear in mind that, against the background of an extraordinarily integrated global economy, the constant search for a high degree of consensus and coordination should not be confined solely to the domestic front. Spain should seek to play a notable role in the design of supranational policies, especially in the context of the euro area, since these measures have a crucial impact on our economy.

Thank you.

23 June 2020

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