1

RISKS LINKED TO THE MACRO-FINANCIAL ENVIRONMENT

The headway made in global vaccination is helping to reduce restrictions on activity, despite some heterogeneity by geographical area. This has translated into a relatively widespread economic recovery. It is also reflecting in lower uncertainty, a favourable macroeconomic outlook in the medium and long term and an improvement in the non-financial sectors' financial position. However, certain segments continue to show greater financial vulnerability than before the COVID-19 crisis. At the same time, risks linked to the adverse unfolding of the pandemic, to the recent disruptions in the global production chains and to a sharper and more persistent than expected increase in inflation, which could lead to a faster withdrawal of monetary stimuli than anticipated by the financial markets, persist. The materialisation of these risks might trigger abrupt asset price corrections in the international markets, adversely impacting economic growth and financial intermediaries' credit risk. Greater buoyancy in demand and prices has also been observed in the Spanish real estate market, but the risks to financial stability appear to be contained for the time being.

1.1 Macroeconomic environment

1.1.1 Systemic and materially significant countries

Global economic activity has continued to recover in 2021, albeit at a more moderate pace in recent months. Against a backdrop of the spread of the COVID-19 Delta variant, activity patterns in advanced and emerging market economies have tended to diverge (see Chart 1.1.1), in good measure owing to the uneven levels of vaccination and to the differences in economic policy support.[1] Also, the appearance of bottlenecks in the global supply chains, prompted among other factors by the rapid recovery in demand in advanced countries and by rising commodity and transport prices, is affecting production, particularly in the manufacturing sector (see Chart 1.1.2).[2]

The recovery of activity has been accompanied globally by considerable inflation rate hikes (see Chart 1.1.3). These increases arise from various idiosyncratic factors which are, in principle, temporary. They include the base effects

1 See Quarterly report on the Spanish economy 2021 Q3, Economic Bulletin.

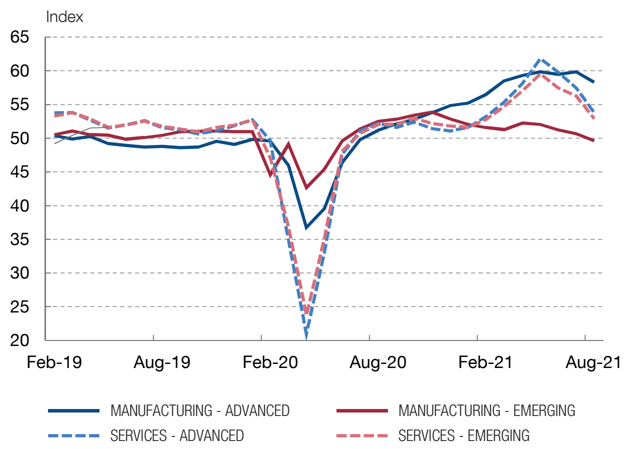
2 See Box 3 "Euro area manufacturing bottlenecks", Quarterly report on the Spanish economy 2021 Q3, Economic Bulletin.

Chart 1.1

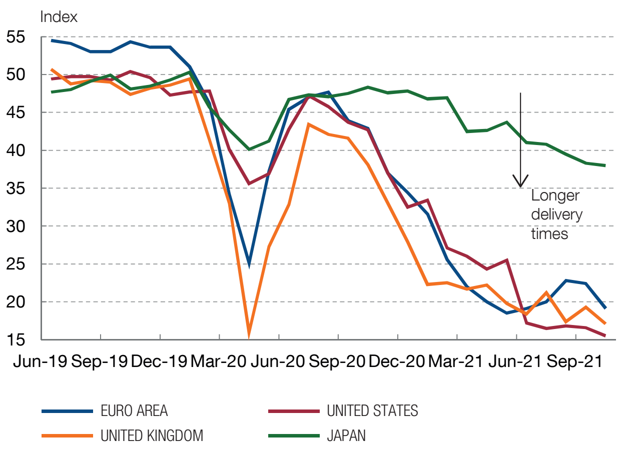
THE GLOBAL ECONOMY CONTINUES TO RECOVER IN 2021, BUT WITH DOWNSIDE RISKS DERIVING FROM UNCERTAINTY OVER THE UNFOLDING OF THE PANDEMIC, THE PERSISTENCE OF BOTTLENECKS AND A POSSIBLE TIGHTENING OF FINANCIAL CONDITIONS

The easing of restrictions to mobility has helped to consolidate the economic recovery over 2021, albeit with diverging outlooks between advanced and emerging market economies as a result of uneven vaccination rates and degrees of economic policy support. Global inflation rates have increased in recent months, in principle owing to temporary factors.

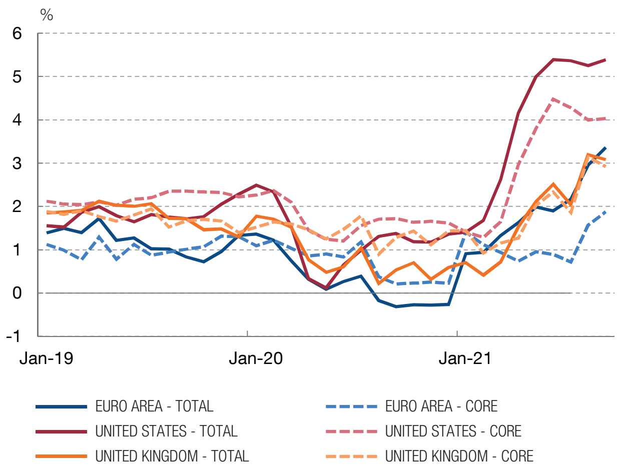
1 PMI IN ADVANCED AND EMERGING MARKET ECONOMIES



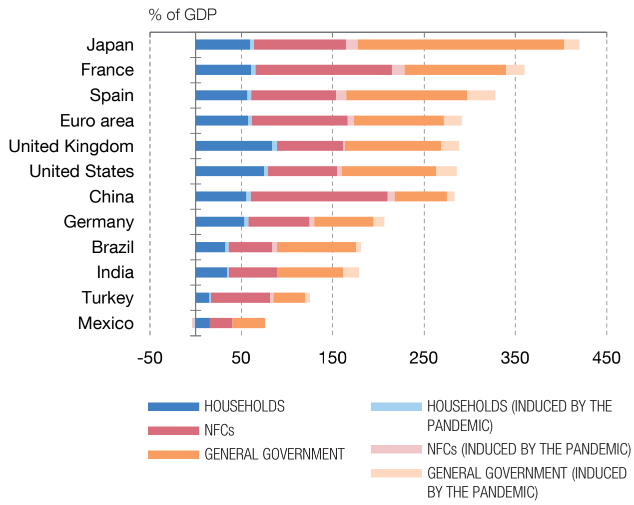
2 PMI MANUFACTURING: SPEED IN SUPPLIER DELIVERY TIMES



3 INFLATION IN ADVANCED ECONOMIES



4 DEBT BY INSTITUTIONAL SECTOR (a)



SOURCES: IHS Markit, national statistics and Institute of International Finance Global Debt Monitor.

a The levels of debt in 2019 Q4 are shown in solid colours while the change between 2019 Q4 and 2021 Q2 is shown in translucid colours.

derived from sharp falls in some services prices recorded at the height of the pandemic; the rise in energy and commodity prices from the abnormally low levels recorded in the summer of 2020; and, in 2021 Q3, the aforementioned impact of the global value chain disruptions on industrial prices and their potential pass-through to consumer prices. In certain areas, the degree of fiscal policy expansion necessary to speed up the recovery may also be playing a role.

The current medium-term prospects of consolidation of the global economic recovery and a return to moderate inflation rates are subject to significant uncertainties. The progressive resolution of the global health crisis, on which the outlook of ongoing improvement in activity is based, is not guaranteed. The main risks include the slow pace of vaccination outside the main advanced economies and the possible spread of new, more resistant and infectious variants of the virus. Despite the prevalence of negative output gaps, the sectoral mismatches that are arising between a buoyant demand and a supply that is slower to respond to the recovery, owing to the appearance of bottlenecks causing recent increases in certain prices, may be more persistent than expected. This could lead to second-round effects and to core inflationary pressures as a result of the de-anchoring of inflation expectations, particularly in economies with a low level of monetary policy credibility.

Despite the favourable expectations for internal demand, especially in the advanced economies, the recovery continues to depend on the adequate calibration of monetary and fiscal policy stimuli. A premature withdrawal of such support may have highly adverse consequences. Thus, a faster and more intense normalisation of monetary policy than expected, particularly in the United States, might lead to abrupt corrections in asset prices. These corrections would bring about adverse effects on global financial conditions and activity in a setting of high vulnerability owing to the significant increase in public and private debt in many countries (see Chart 1.1.4). Likewise, an early withdrawal of fiscal stimuli in other areas, owing to possible political or market pressures, could lead to a reassessment of expectations regarding the repayment capacity of the most heavily indebted private agents, particularly non-financial corporations. The recent liquidity difficulties and the possible insolvency of China's main real estate company, Evergrande, which had resorted heavily to external financing over the last five years, illustrates the types of risks generated by the above-mentioned increase in indebtedness. In the hypothetical case that these problems were to extend to the rest of the real estate sector or to the Chinese financial system, there would be severe consequences for growth in China, with contagion effects for the rest of the world.

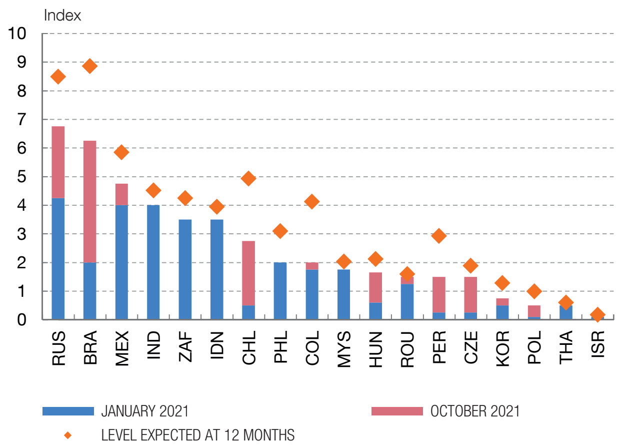
Financial conditions have tightened somewhat in the emerging market economies, although they continue to be globally favourable. The increase in inflation has led to the start of a cycle of policy interest rate hikes in many countries in Latin America[3] and Eastern Europe, to avoid possible second-round effects and a de-anchoring of inflation expectations (see Chart 1.2.1). Also, economies with greater fiscal vulnerabilities, or those recording episodes of social and political tension, have observed an increase in local-currency long-term interest rates, a depreciation of their currencies against the dollar and an increase in the external sovereign debt

3 See the Report on the Latin American economy. Second half of 2021. Outlook, vulnerabilities and policy space, October 2021.

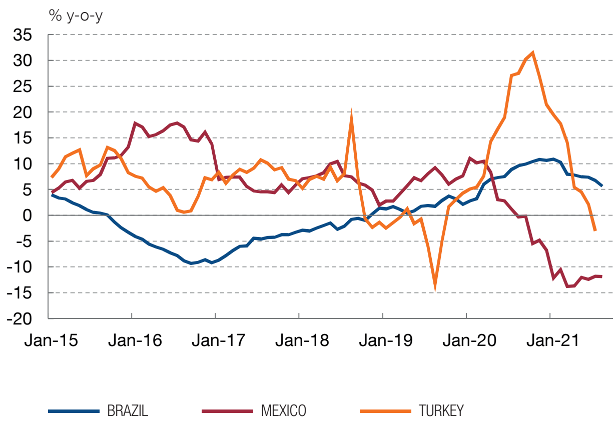
Chart 1.2
HIGHER INFLATION EXPECTATIONS EXERT UPWARD PRESSURE ON INTEREST RATES IN THE EMERGING MARKET ECONOMIES, WHILE CREDIT LOSES MOMENTUM

Emerging market economies' central banks have started to tighten their monetary policies and are expected to continue doing so over the next twelve months, as credit growth moderates in light of the total or partial withdrawal of public credit support plans in most of these economies.

1 POLICY INTEREST RATES IN EMERGING MARKET ECONOMIES



2 RATE OF CHANGE IN CREDIT TO THE PRIVATE SECTOR



SOURCES: Refinitiv and national statistics.

yield spreads. Also, the total or partial withdrawal of credit support plans in most of these economies has prompted a marked slowdown in bank lending, with possible adverse effects on the activity of these material countries for the Spanish banking system (see Chart 1.2.2).

A potential deterioration of the growth outlook in light of an unfavourable unfolding of the health situation might negatively affect the financial markets of these economies and tighten their financial conditions, as economic policies would have less room for manoeuvre. They might also be particularly affected in the event that the monetary policy stance in the advanced economies tightened more than expected or if national monetary policies had to face persistent inflationary or exchange rate pressures. The following can be noted in regard to the main emerging market countries with Spanish banking exposures:

In **Mexico,** the economy continued to recover during 2021 H1. However, there is a high degree of unevenness between the performance of services, supported by the progress made in the vaccination process, and the manufacturing sector, affected by global supply chain problems. The Mexican economy is exposed to risks similar to those of other emerging market economies, although it is more closely linked to the performance of the US economy. On the positive side, it has buffers against shocks, such as the swap line with the Federal Reserve and the flexible credit line with the International Monetary Fund. However, political uncertainty in the domestic and international fronts might negatively affect investment, which has been sluggish in recent years.[4]

In **Brazil** GDP growth stagnated in Q2, after a surprising rise in Q1. The country continues to accumulate imbalances in fiscal territory. Public debt is close to 90% of GDP and largely financed at interest rates linked to inflation or to the policy interest rate, which share a very pronounced upward trend. In addition, this debt is mostly acquired by domestic banks or their investment funds, which raises the sovereign-bank nexus risk. Against this backdrop, the fiscal adjustment envisaged is subject to significant uncertainties. Political tensions have also increased significantly, and they are not expected to weaken in the short term in view of next year's presidential elections. Indeed, Brazil's financial markets have performed relatively worse, feeding back into fiscal vulnerabilities.

In **Turkey,** in 2021 H1 the economy continued to show significant buoyancy and notable imbalances which, however, have moderated with the gradual withdrawal of some stimulus measures such as the credit support. Bank lending slowed notably, with the exception of consumer loans, which maintained a strong growth rate. Although still significant, the current account deficit has decreased. Nonetheless, inflation has rebounded, standing at 19.6% year-on-year in September. Against a backdrop of sizeable external financing needs and very low international reserves, the Turkish economy's biggest risk is the loss of confidence from the financial markets. This could be the result of reductions in policy interest rates, as occurred in September and October, that may prove to be early or greater than that discounted by investors.

1.1.2 Spain

The baseline projections for the Spanish economy envisage, for the short term, a continued recovery, favoured by the headway made in the vaccination campaign, the consequent lifting of the pandemic containment measures and the economic policy support. This would help to recover the pre-health crisis level of activity over the horizon considered in the Banco de España's most recent projections, which cover up to 2023[5] (see Chart 1.3.1). Activity would grow more during the first half of the projection period, boosted by the epidemiological improvement and by the implementation of NGEU programme projects.

4 An example of external tensions in the case of Mexico is the application of the U.S.-Mexico-Canada trade agreement (USMCA) rules, which were worded ambiguously and leave room for different interpretations. In recent months, divergences have arisen between the United States and the other treaty members which might particularly affect the Mexican automotive sector.

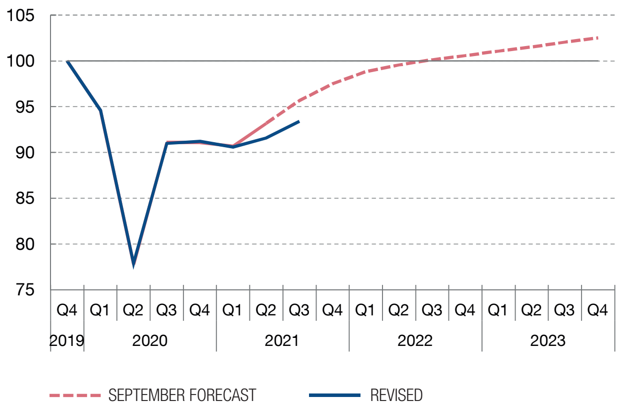
5 See Box 1 "Macroeconomic projections for the Spanish economy (2021-2023)", Quarterly report on the Spanish economy, September 2021.

Chart 1.3

THE BASELINE FORECASTS FOR THE SPANISH ECONOMY ENVISAGE HIGH DYNAMISM AT SHORT TERM, ALTHOUGH CERTAIN ECONOMIC AND HEALTH RISKS PERSIST

The projections for the Spanish economy envisage high buoyancy in activity in 2021 and 2022, underpinned by the normalisation of economic relations and the maintenance of economic policy support. The pre-COVID-19 level of activity would recover over the forecast horizon, which covers up to 2023. The most significant downside risks include the potential negative effect of bottlenecks in the global production chains and a more persistent inflation increase than currently expected. Some uncertainty persists, although less than in previous quarters, over the health situation, which affects certain sectors in particular (e.g. accommodation and food service activities).

1 REAL GDP IN SPAIN. LEVEL (a)
(100 = 2019 Q4)



2 INDICATOR OF DISAGREEMENT OVER GDP EXPERT FORECASTS FOR 2021 AND 2022 (b)

SOURCES: Instituto Nacional de Estadistico and Banco de España.

a The Banco de España's September 2021 macroeconomic projections are shown. Their cut-off date was 14 September 2021 and they included the data available to that date, specifically the GDP flash estimate for 2021 Q2. Subsequently, the INE has published new data, which include the revision of Q2 and previous quarters and the flash estimate for 2021 Q3.

b See C. Ghirelli et al. (2021), "Measuring economic and economic policy uncertainty and their macroeconomic effects: the case of Spain", Empirical Economics. A decline in this indicator, constructed on the basis of the standard deviation of forecasters' projections of changes in GDP for 2021 and 2022, reflects greater certainty over the behaviour of this macroeconomic aggregate over this period.

Uncertainty regarding the Spanish economy's growth path has declined, in line with the recent improvements in the health and economic situation. Recent favourable epidemiological and economic developments in Spain have helped to reduce uncertainty over economic growth in the short and medium terms, in line with the behaviour observed in other advanced economies (see Chart 1.3.2).

Yet developments in the Spanish economy are influenced by several factors, including the possibility of greater persistence of disruptions to global value chains and increasing inflation. First, if the supply problems recently observed in the global production chains ultimately weigh down on economic activity worldwide markedly and persistently, certain industrial sectors in Spain will be affected more durably. Another downside risk to activity, which has recently grown stronger, is the possibility of an increase in commodities and intermediate goods prices that is less temporary than currently assumed, with the consequent compression of households' and firms' income in real terms. This greater persistence could lead to the transfer of cost increases to final prices and wage demands, resulting in a more pronounced and long-lasting rise in inflation than that anticipated at this point in time.

Certain downside risks related to the unfolding of the pandemic and its impact on economic activity also persist. These downside risks are related to the spread of new COVID-19 variants potentially more resistant to vaccines, which could lead to reinstating restrictions to mobility. They may also be related to the more persistent effects of the crisis on the business sector and employment. By contrast, if the health situation improves faster than forecast, economic growth might also gain momentum, mainly owing to a more pronounced freeing up by households of the stock of savings generated during the pandemic or to an early reactivation of spending by foreign tourists.

1.2 Financial markets and the real estate sector

1.2.1 Financial markets

The stock market indices in the main developed economies have tended to appreciate over the last few months. This was underpinned by the progress made in the vaccination campaign, the maintenance of an accommodative monetary policy stance and better corporate earnings than anticipated by the markets. However, some episodes of stock market price corrections have also been observed, mainly linked to fears regarding the impact of the spread of the COVID-19 Delta variant on economic growth, to the fear of a contagion effect of the Chinese Evergrande real estate crisis and to investor concerns about inflationary pressures possibly leading to the withdrawal of monetary stimuli earlier than envisaged. The S&P 500 index reached new all-time highs, accumulating a gain of 8.7% at the cut-off date for this report with respect to the levels at end-April. In the same period the EURO STOXX 50 appreciated by 5.4%, while the IBEX 35 rose less (1.0%), affected by the negative impact of the spread of the pandemic in Spain over the summer in the sectors most exposed to it, such as leisure and tourism (see Chart 1.4.1).

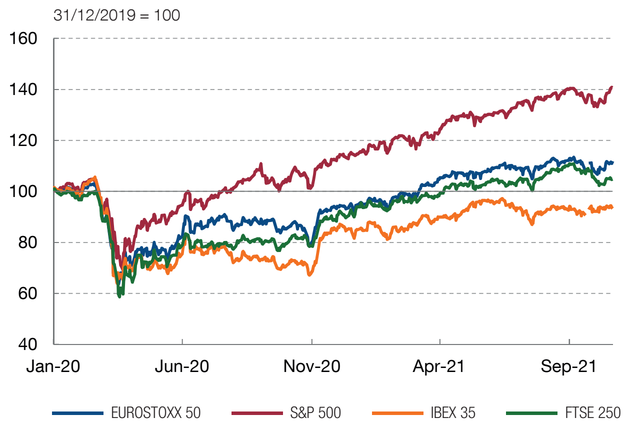
The long-term yields of higher-rated sovereign bonds fell between April and end-August and have rebounded since then, while sovereign and corporate risk premia have remained at low levels. The increase in long-term risk-free interest rates in recent months is linked to the rise in the upside medium-term inflation risks perceived by the financial markets. Following these movements, the long-term yields of higher-rated sovereign bonds stand at levels close to or even above (in the case of the UK and German benchmarks) those seen in Spring and much higher than posted at the start of the year (see Chart 1.4.2). The estimates available also point to an increase in term premia in recent months, although they currently remain well below their historical averages (see Chart 1.4.3). Also, since August long-term real interest rates have risen less than nominal interest rates (United States) or have even continued to fall in certain areas (the euro area), reaching highly negative levels (close to their all-time lows). This very low level of long-term

Chart 1.4

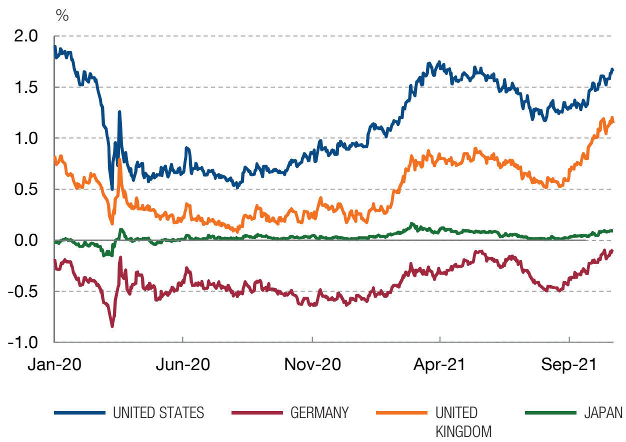
STOCK MARKET INDICES HAVE RISEN, SOVEREIGN DEBT YIELDS HAVE INCREASED SINCE AUGUST AND SOVEREIGN AND CORPORATE RISK PREMIA HAVE REMAINED AT LOW LEVELS

Positive corporate earnings and an accomodative monetary policy stance have supported the rise in stock market indices in international markets, although they have also been affected by one-off corrections. Long-term sovereign bond yields decreased between April and August and have rebounded thereafter, conditioned by the increase in the upside medium-term inflation risks perceived by the financial markets. Following these movements, these yields stand at levels much higher than at the beginning of the year. Despite these developments, term premia and long-term real interest rates remain at very low levels from a historical perspective. Euro area sovereign risk premia and non-financial corporations' bond premia have remained at low levels, supported by the continuation of accommodative monetary conditions and lower concern for credit risks.

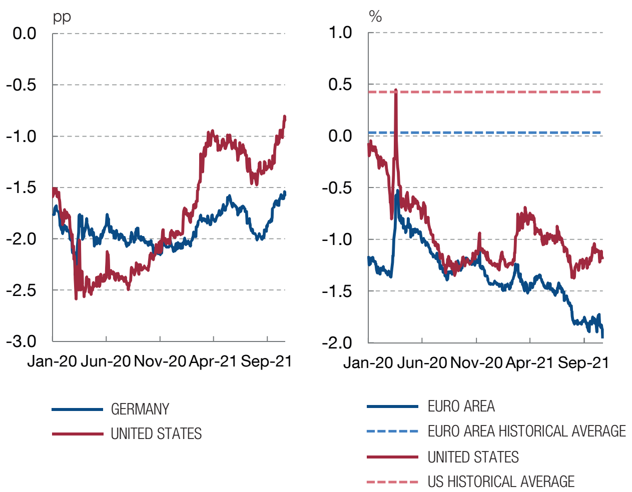
1 STOCK MARKET INDICES



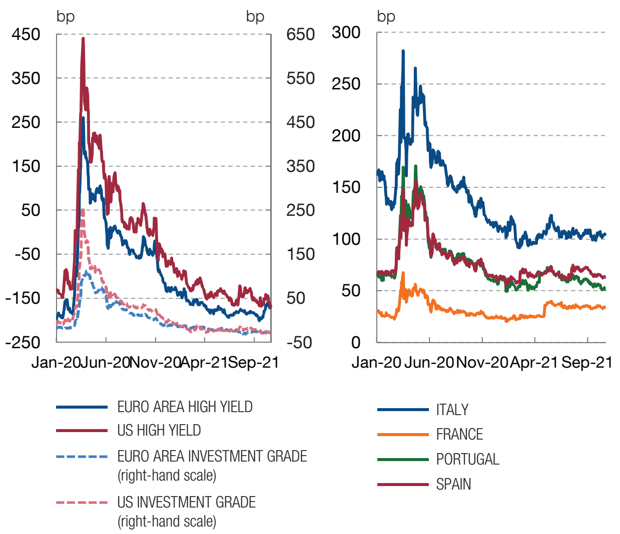
2 10-YEAR SOVEREIGN BOND YIELDS



3 DEVIATION FROM THE HISTORICAL AVERAGE OF THE TERM RISK PREMIUM IN THE 10-YEAR GOVERNMENT BOND INTEREST RATE (LEFT) (a) AND THE 10-YEAR REAL INTEREST RATE (RIGHT) (b)



4 DEVIATIONS FROM THE HISTORICAL AVERAGE OF NON-FINANCIAL CORPORATIONS' BOND SPREADS RELATIVE TO THE SWAP CURVE (LEFT) (c) AND THE 10-YEAR GOVERNMENT BOND SPREAD AGAINST GERMANY (RIGHT)



SOURCES: Refinitiv Datastream and Banco de España.

a Term risk premia are obtained from a decomposition of 10-year interest rates into risk premia by term and expectations of short-term interest rate changes. The expectations are obtained by forecasting the future short-term instantaneous interest rate using an ARFIMA model on each of the interest rate curve components (long-term level, slope and curvature) estimated daily. Once the short-term interest rate change expectations are obtained, the premium is obtained as the difference between the 10-year rates and the short-term rate expectations. The historical averages of the term premia are calculated between 2003 and 2021.

b The historical average of the 10-year real interest rate in the euro area and the United States is calculated between 2004 and 2021. Until July 2008 in the euro area and June 2007 in the United States the data on French and US inflation-linked bonds are used. Thereafter, real interest rates are calculated in the euro area as the difference between the 10-year overnight indexed swap and the 10-year inflation compensation and in the United States as the difference between the 10-year government bond and the 10-year inflation compensation.

c High yield: ICE Bank of America Merrill Lynch Non-Financial High Yield Index. Investment grade: ICE Bank of America Merrill Lynch Non-Financial Index. Deviations are calculated relative to the historical average between 1998 and 2021.

risk-free real interest rates appears to be linked to various structural factors (demographic factors, low productivity growth, greater inequality, high demand for safe assets, etc.) and to other more conjunctural factors, such as, in particular, central banks' asset purchase programmes. This factor has continued contributing to euro area sovereign risk and non-financial corporations bond premia remaining at low levels (see Chart 1.4.4). The latter, except in the high yield segment in the euro area, have even declined in recent months, currently standing below their historical average. This might be due to lower market concern for non-financial corporations' credit risks, which would be in line with the more favourable performance of defaults and the positive balance between upward and downward credit rating revisions in recent months. However, around one third of the outstanding balance of debt issuances in the euro area with BBB rating continues to have a negative outlook. Box 1.1 analyses in depth the factors determining sovereign debt long-term interest rates in Europe and the United States.

A potential earlier than expected withdrawal by the markets of central banks' monetary stimuli might raise long-term risk-free interest rates further and trigger corrections in asset prices. This scenario could materialise, for example, if the rise in inflation observed in the advanced economies were more persistent than anticipated. The possible increase in yields could be transferred more intensely to corporate bonds, since their risk premia are abnormally low according to their historical relationship with their usual determinants, such as enterprise value and uncertainty over enterprise value, leveraging and risk aversion (see Chart 1.5.1). This seems to be related to the persistence of very accommodative monetary conditions.[6] In the stock markets, although risk premia do not appear to have been so influenced by expansionary monetary policies and are currently above their historical average, these developments could lead to a fall in share prices. In fact, their current high level, compared with firms' earnings, seems to be largely due to low long-term real interest rates (see Chart 1.5.2). In any event, the impact of an increase in long-term interest rates on the price of risk-bearing assets would probably be cushioned if this movement were accompanied by an improvement in the macroeconomic outlook, given the beneficial effect this would have on the economic and financial position of the issuers of these assets.

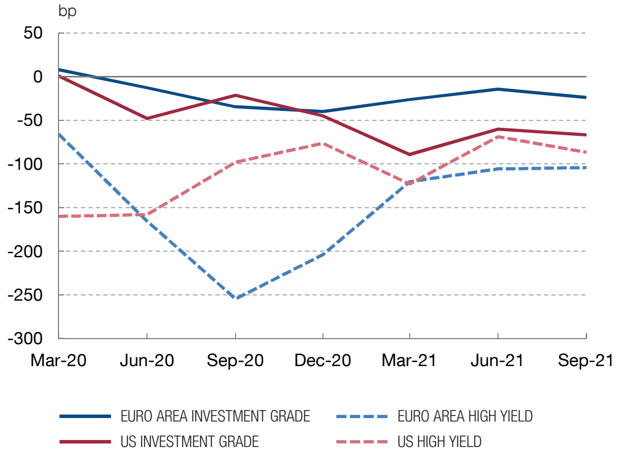
Under this hypothetical correction scenario, there would also be a tightening of financing conditions with possible adverse implications for credit risk. First, this shock could reduce economic agents' spending, negatively affecting economic growth. Second, in this scenario, indebted agents' financial burden would tend to increase, although the speed and intensity of this effect would depend on the structure of their liabilities and on how interest rates evolve over the different maturities.

6 For further details, see Box 1.1 of the Financial Stability Report Spring 2021 and J.M. Gálvez and I. Roibás (2021), "Asset price misalignments in financial markets: an empirical analysis", Working Paper, Banco de España (forthcoming).

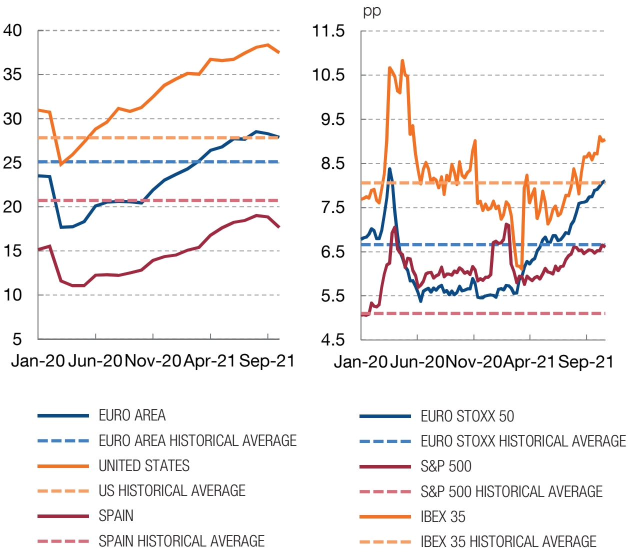
Chart 1.5
PRICES OF RISK-BEARING FINANCIAL ASSETS ARE STILL HIGH COMPARED WITH SOME OF THEIR DETERMINANTS

Corporate credit risk premia are below the level warranted by their historical relationship with determinants such as enterprise value and uncertainty over enterprise value, leveraging or risk aversion. For their part, stock prices in the United States and the euro area are high compared with the cyclically-adjusted earnings of listed firms. This appears to be explained not by low stock market risk premia (which are above their historical average) but rather by low long-term real interest rates.

1 CORPORATE CREDIT RISK PREMIA, DEVIATIONS FROM HISTORICAL DETERMINANTS (a)



2 CYCLICALLY-ADJUSTED PER (LEFT-HAND PANEL) (b). STOCK MARKET RISK PREMIUM (RIGHT-HAND PANEL) (c)



SOURCES: Refinitiv Datastream and Banco de España.

a The difference between the corporate credit risk premium observed and that predicted by a corporate bond valuation model based on four factors: expected enterprise value (EV), uncertainty over expected EV, corporate sector leverage, and investor risk aversion. For more details, see Galvez and Roibás, "Asset price misalignments: an empirical analysis", Working Paper (forthcoming), Banco de España.
b The cyclically-adjusted PER is calculated as the ratio of the share price to the 10-year moving average of earnings. The historical averages are calculated for the period 1997-2021.
c The stock market risk premium is calculated using a 2-stage dividend discount model. For more details, see Fuller and Hsia (1984), "A simplified common stock valuation model", *Financial Analysts Journal.* The historical averages are calculated for the period 2006-2021.

A potential worsening of the macroeconomic outlook or an increase in the uncertainty surrounding it might also trigger price corrections in corporate bonds and shares in the international markets. This scenario might arise, for instance, if the risks described in the previous section were to materialise. This would translate into a reduction in the expected future path of firms' earnings or greater uncertainty about said path, which would adversely affect the value of shares through its negative impact on shareholder remuneration. Corporate bond prices would be affected to the extent that this situation causes risk premia to rise through an increase in perceived credit risks or lower investor tolerance thereto.

1.2.2 Spanish real estate market

House sales rose sharply in the first eight months of 2021, by almost 14% over the same period of 2019, in contrast to housing supply which was more

contained. The recent housing demand dynamics appear to be backed, not only by the improvement in the general economic situation and the accommodative financial conditions, but also by the materialisation of investment decisions that had been postponed following the onset of the pandemic and by changes in households' housing preferences arising from that shock (see Chart 1.6.1). In particular, these changes are being reflected in a comparatively more dynamic demand for single-family homes and new housing. But housing supply is less dynamic and, were the current patterns to continue, it could be insufficient to absorb higher demand in the coming years. In any event, in the medium term, the Housing Renovation and Urban Regeneration Plan, to be implemented within the framework of the Recovery, Transformation and Resilience Plan (RTRP), which has funding of €6,820 million out of the NGEU funds, could drive activity in the residential sector, including both renovation and new housing.

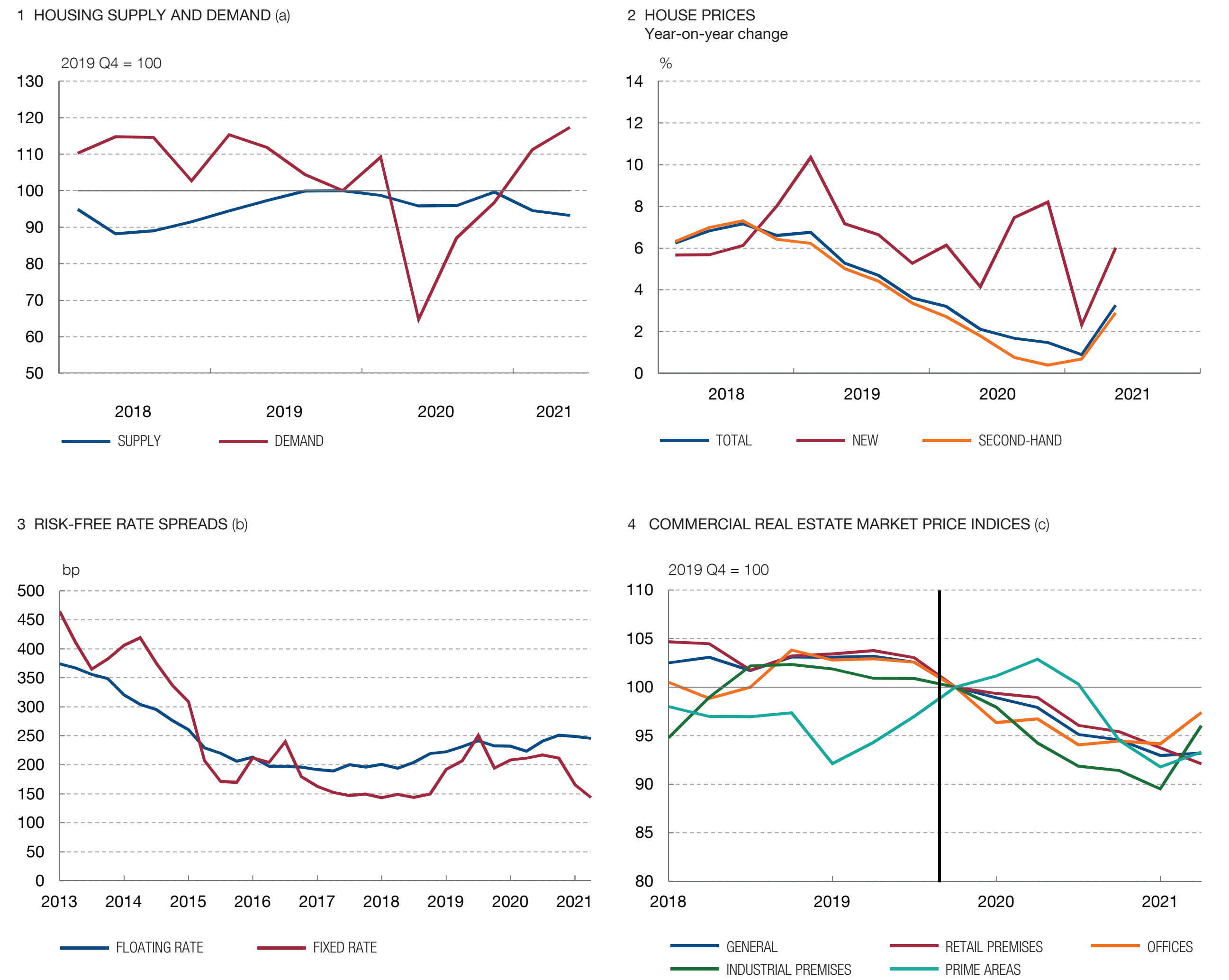
This increase in house purchases prompted an acceleration in average house prices in Q2, reversing the slowdown observed since early 2019. House prices, which rose by 3.3% year-on-year (see Chart 1.6.2), were stronger both in the new housing segment (6%) and, to a lesser extent, in second-hand housing (2.9%). New house prices have risen the most in recent years, which could be related to the fact that new housing can be more easily adapted to buyers' preferences and is in shorter supply than second-hand housing. Going forward, the recent sharp increase in the cost of building industry inputs, were it to persist, could put further pressure on new house prices. It should also be borne in mind that the growth in activity stemming from the implementation of the RTRP could further tighten the costs of building industry inputs and labour. Despite these recent developments in house prices, there are still no signs that these prices are, on average, significantly above their long-term equilibrium level (see Chapter 3 of this report).

In keeping with the greater dynamism of house sales, new mortgage loans also recorded strong growth in 2021 H1. Specifically, new lending for house purchase was some 40% higher than in 2019 H1. Nevertheless, the outstanding amount of mortgage lending has increased very moderately, as mortgage repayments have also risen, possibly because households have used the savings they accumulated in the early stages of the pandemic to early repay all or part of their mortgage loans. Another possible factor is the end of the moratorium programmes, which entails the restart of mortgage repayments that had been suspended.

This mortgage loan growth essentially appears to respond to demand-side factors, as there are no signs of easing of credit standards in recent months, although interest rate spreads in the fixed-rate mortgage segment have narrowed recently. For instance, average loan-to-price (LTP) ratios have held quite steady in recent months, although for floating-rate mortgages they have dipped slightly; this suggests that mortgage lending criteria may have become somewhat more stringent. Moreover, the proportion of mortgage loans with LTP ratios over

Chart 1.6
HOUSE SALES AND PRICES HAVE ACCELERATED SIGNIFICANTLY IN 2021 TO DATE, WHILE AVERAGE PRICES OF COMMERCIAL REAL ESTATE SHOWED SOME SIGNS OF RECOVERY IN Q2

Housing transactions have risen sharply in 2021 to date compared with the same period of 2019, while housing supply dynamics have been weak. Accordingly, average house prices accelerated in Q2, especially in the new housing segment. Although mortgage conditions have remained generally steady, fixed-rate mortgage spreads have narrowed significantly in the year. In the commercial real estate market, average prices fell again in Q1, followed by some signs of recovery in Q2.



SOURCES: Instituto Nacional de Estadistica, Ministerio de Transportes, Movilidad y Agenda Urbana, TINSA, Colegio de Registradores and Banco de España.

a Housing supply comprises new housing, proxied by building completion certificates, and second-hand housing, proxied by the net supply of housing on the main real estate portals compiled by TINSA. Housing demand data refer to housing sales published by INE.
b The rate spread of each new mortgage over the euro IRS curve or swap curve. For floating-rate mortgages, the 1-year IRS rate is used to calculate the spread; for fixed-rate mortgages, the term equivalent to the mortgage term is chosen. The chart depicts the median of the spreads for the two types of mortgages. The 2021 Q2 data are provisional.
c To calculate these indices, each market is divided into strata of homogeneous real estate. A price is then estimated for each stratum, using a hedonic regression model. The indices aggregate the estimated price data for each stratum. The 2021 Q2 data are provisional.

80% has not increased. Interest rate spreads have remained steady for floating-rate mortgages, but fixed-rate spreads have narrowed to their lowest levels in recent years (see Chart 1.6.3). At the same time, fixed-rate mortgage maturities have lengthened and their share of new mortgages has increased.

In the commercial real estate markets, prices fell back again in 2021 Q1, but showed some signs of recovery in Q2. By market segment, prices of offices and industrial premises rose moderately in Q2, but prices of retail premises, which make up the majority of commercial real estate, continued to fall (see Chart 1.6.4). The average price of real estate in prime locations (the prime segment) also rose in Q2, after the decline observed since the start of the health crisis.

1.3 Non-financial sectors

1.3.1 Non-financial corporations and households

The economic situation of firms evolved favourably throughout 2021 H1, although with a notable degree of heterogeneity across sectors. Corporate earnings posted a strong recovery, so that in most branches of activity turnover returned to 2019 H1 levels (see Chart 1.7.1). However, in the economic sectors most affected by the COVID-19 crisis,[7] sales grew more moderately and are still well short of pre-pandemic levels. These more favourable developments in terms of business activity have driven up firms' profitability. Thus, on Central Balance Sheet Data Office Quarterly Survey (CBQ) data, the percentage of firms in 2021 H1 with negative return on assets (ROA)[8] is 8 pp lower than in the same period a year earlier, although it is still 5 pp higher than in 2019[9] (see Chart 1.7.2). This is consistent with the microsimulations made by the Banco de España, which project a gradual recovery in corporate earnings this year and over the next two years, in keeping with the greater economic dynamism expected. Nevertheless, this improvement will be slower in the economic sectors most affected by the health crisis, and is subject to the business risks indicated in section 1.1 above.[10]

The recovery in economic activity, the halt in the tightening of credit standards[11] and longer average debt maturities all appear to be helping ease firms' liquidity risks. Overall, in firms' debt maturity structures, longer maturities account for a higher share of the total than they did before the COVID-19 crisis, partly owing to the Official Credit Institute (ICO) guarantee scheme. Recent developments in average

7 The economic sectors most affected by the COVID-19 pandemic are those whose turnover in 2020 was down more than 15% on 2019, specifically: hospitality, oil refining, social and cultural services, transportation and storage, the textile industry and the manufacture of transport equipment.

8 Return on assets = (Ordinary net profit + Financial costs) / Net assets (net of non-interest-bearing borrowing).

9 See "Results of non-financial corporations to 2021 Q2", Analytical Articles, *Economic Bulletin* 4/2021, Banco de España.

10 See "Impact of the COVID-19 crisis on Spanish firms' financial vulnerability", *Occasional Paper* No 2119, Banco de España.

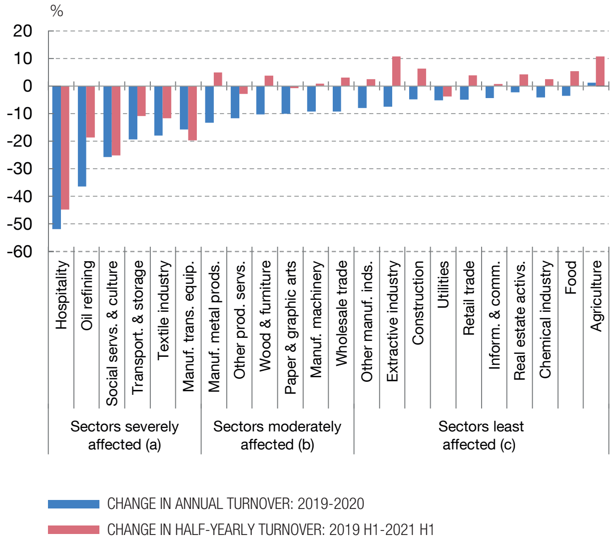
11 See "The July 2021 Bank Lending Survey in Spain", Analytical Articles, *Economic Bulletin* 3/2021, Banco de España.

Chart 1.7

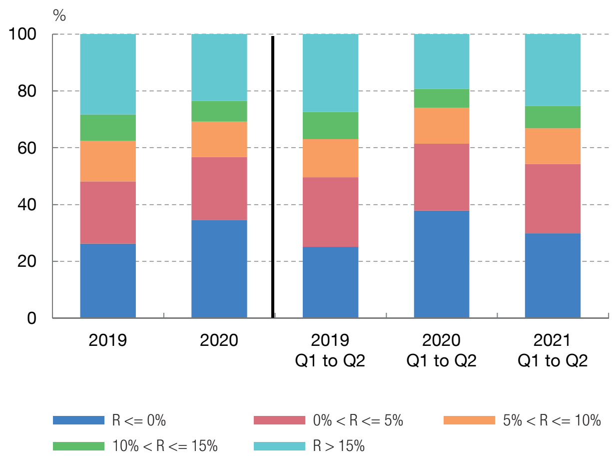
FIRMS' SALES AND PROFITABILITY HAVE IMPROVED, ALBEIT VERY UNEVENLY ACROSS ECONOMIC SECTORS

During the first half of the year, business turnover in most economic sectors returned to pre-pandemic levels. However, in the sectors severely affected by the health crisis, the recovery is proving to be slower and activity is still clearly below 2019 levels. Growth in corporate earnings has translated into an – albeit still incomplete – improvement in profitability.

1 BUSINESS TURNOVER BY SECTOR
Rate of change compared with same period of 2019



2 PERCENTAGE OF FIRMS BY RANGE OF ORDINARY RESULTS (ROA) (d)



SOURCES: Agencia Estatal de Administración Tributaria and Banco de España.

a Economic sectors severely affected: those whose turnover fell by more than 15% in 2020.
b Economic sectors moderately affected: those whose turnover fell by more than 8% but less than 15% in 2020.
c Economic sectors least affected: those whose turnover fell by less than 8% in 2020.
d CBQ data. Return on assets (R) = (Ordinary net profit + Financial costs) / Net assets (net of non-interest-bearing borrowing).

payment periods to suppliers, which on CBQ data returned, in 2021 Q2, to levels similar to their pre-pandemic levels, also point to a drop in liquidity tensions.[12]

The risks related to the solvency of non-financial corporations also appear to be easing, as the recovery in economic activity has been accompanied by lower debt growth. In consequence, average debt and debt burden ratios have fallen, in the case of the latter driven also by the decline in the average cost of outstanding debt. Developments in the volume and quality of bank debt and the use of support measures such as the ICO guarantees have been uneven across economic sectors and firms (see Chapter 2 of this report).

The economic situation of households has also recovered, as evidenced by recent household income and labour market developments, but again with a

12 See Box 1, "Recent developments in trade finance granted and received by non-financial corporations", in "Results of non-financial corporations to 2021 Q2", Analytical Articles, Economic Bulletin 4/2021, Banco de España.

certain degree of heterogeneity. Specifically, households' gross disposable income (GDI) rose by 1% in 2021 H1, but it is still 3.9% below the 2019 levels. Also, at September 2021, effective social security registrations[13] were barely 1.2% lower than their pre-pandemic levels (see Chart 1.8.1), placing the number of employed workers of the Labor Force Survey (EPA), in this same period, above those observed before the pandemic. Similarly, according to the European Commission's consumer survey, at that date households either expected their economic situation to improve over the next 12 months (households in the top two income quartiles) or to hold relatively steady (households in the bottom two income quartiles)[14] (see Chart 1.8.2). It must also be borne in mind that since the start of the year there has been a significant cutback in some of the household income support measures, such as the loan moratoria,[15] and this will have had most impact on the more vulnerable households.

The average debt ratio rose slightly in 2021 H1, while the average debt burden ratio fell due to the decline in the average cost of outstanding debt. Thus, the debt-to-GDI ratio stood at 94.9% in June, 4.2 pp above the pre-pandemic level, while the debt burden-to-GDI ratio was 0.5 pp above its pre-pandemic level.

The more granular data point to different lending dynamics according to certain household characteristics. Households that had loans before the outbreak of the pandemic have generally reduced their level of debt, albeit at an increasingly more moderate pace. The lowest reductions in the outstanding sum of bank loans are recorded among higher income households (proxied according to income by postcode) and among those resident in the municipalities hardest hit by the crisis (proxied by those with the highest percentage of firms with furloughed workers) (see Chart 1.8.3). The latter might be explained, at least in part, by the greater use made of loan moratoria in the areas most affected by the crisis.[16] An analysis of the new debt taken on by households that had no loans at the onset of the pandemic also shows stronger lending growth in higher income areas and in those hardest hit by the crisis (see Chart 1.8.4). For all households, whether or not indebted at the start of the crisis, income is the variable that best explains credit developments.[17] This suggests that higher income households, and especially those in the top income quintile, were most likely to take on debt and/or to have had greater access to credit since the beginning of the pandemic.

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13 Effective social security registrations are total registrations excluding workers subject to furlough schemes (ERTEs by their Spanish name).

14 See the European Commission's monthly consumer survey.

15 For instance, the application period for bank loan moratoria, with a maximum duration of nine months, ended on 31 March 2021. See Royal Decree-Law 3/2021 of 2 February 2021 adopting measures to narrow the gender gap and on other Social Security and economic matters.

16 See "Support measures in the banking sector: loan moratoria", *Financial Stability Review,* Issue 40, spring 2021, Banco de España.

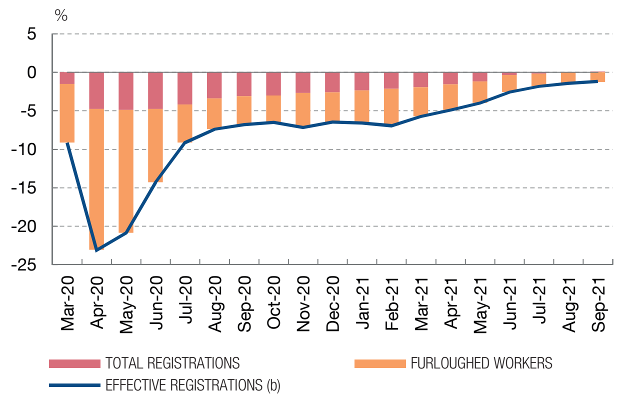
17 Stronger new lending in the municipalities with the most furloughed workers is consistent with debts taken on to meet their current expenditure. However, the positive correlation between income level and the percentage of firms with furloughed workers at the municipal level suggests that this increase in lending could reflect an income effect.

Chart 1.8

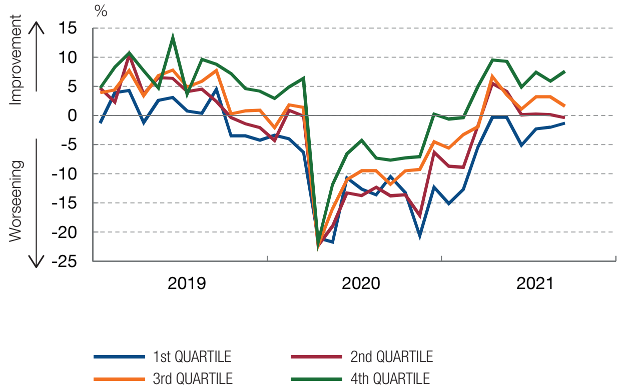
THE ECONOMIC SITUATION OF HOUSEHOLDS ALSO RECOVERED IN 2021 H1, WITH INCOME, EMPLOYMENT AND EXPECTATIONS ALL IMPROVING, ALBEIT UNEVENLY BY EMPLOYMENT SECTOR AND INCOME LEVEL, WHICH ALSO CONDITION HOUSEHOLDS' BORROWING DECISIONS

At September, effective social security registrations were already very close to their pre-pandemic levels; indeed, Labour Force Survey (EPA) employment figures were above those levels. Workers who are still furloughed make up almost all employment still to be recovered. This positive picture of households' situation was also reflected in their expectations for the next 12 months: in September, households expected their economic situation to improve over that horizon (the two highest income quartiles) or to hold relatively steady (the two lowest income quartiles). In general, households with outstanding loans before the health crisis have reduced their debt levels. Higher income households and those resident in municipalities with a higher percentage of firms with furloughed workers have done so to a lesser extent. These population segments also account for much of the new debt taken on by households that had no loans before the pandemic.

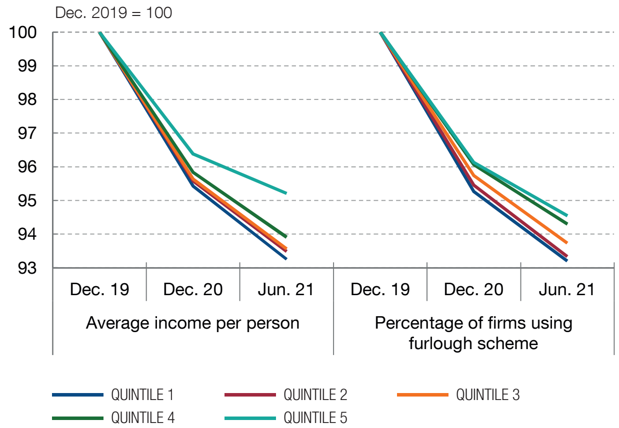
1 EFFECTIVE SOCIAL SECURITY REGISTRATIONS (a)
Change compared with February 2020



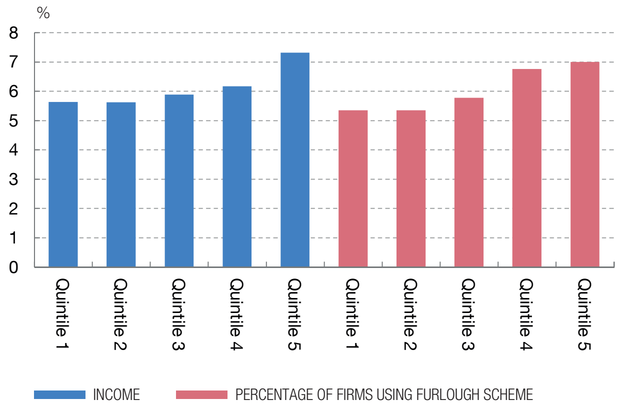
2 EXPECTATIONS FOR THE ECONOMIC SITUATION OF HOUSEHOLDS FOR THE NEXT 12 MONTHS, BY INCOME QUARTILE (c)



3 CHANGE IN LENDING TO HOUSEHOLDS THAT HAD BANK LOANS BEFORE DECEMBER 2019 (d) (e)



4 HOUSEHOLDS WITH NO BANK DEBT AT DECEMBER 2019 (d) (e) (f)



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

a The average data for each month are taken and are seasonally adjusted.
b Effective social security registrations are total registrations excluding furloughed workers.
c Indicator = percentage of households expecting their economic situation to improve significantly × 1 + percentage expecting their economic situation to improve somewhat × 1/2 – percentage of households expecting their economic situation to worsen somewhat × 1/2 – percentage expecting their economic situation to worsen significantly × 1.
d Classification by income quintiles at postcode level. Each postcode is assigned the percentage of firms using the furlough scheme in the corresponding municipality. Households are defined considering individual borrowers (natural persons and sole proprietors). Each individual borrower is assigned the amount of credit resulting from the sum of the proportional part of each of the loans in their name.
e Postcodes in very small municipalities for which no postcode-level income data are available have been excluded. In order for all quintiles to have equal importance, a double allocation criterion has been used in each. The postcodes (municipalities) are ranked by income, by the impact of the furlough scheme (measured as the percentage of firms using the furlough scheme over the number of firms in the municipality in March 2021) and by the stock of credit at the start of the crisis (December 2019). Thus, the first quintile includes the postcodes (municipalities) that account for 20% of loans at the start of the crisis and have the lowest income level or the lowest percentage of firms using the furlough scheme in the municipality, and so on for the other four quintiles.
f The contribution to the change in lending to households that had no bank debt in December 2019 is defined as the ratio of their bank debt in June 2021 (accumulated as a result of new lending since December 2019) to the stock of households' bank loans at December 2019 within each quintile.

The increase in households' aggregate wealth —on account of the rising prices of both financial and real assets and the savings accumulated— has also strengthened the financial position of households. As consumption has increased, the household saving rate has moderated, but it is still above its historical average. In addition, the Household Budget Survey[18] shows that all household income quartiles made a positive contribution to the significant increase in aggregate saving in 2020, although the contribution of lower income households was smaller.

1.3.2 General government in Spain

The latest data available, corresponding to 2021 H1, are beginning to reflect a certain correction in the imbalance in public finances in Spain compared with the high levels reached in 2020. The general government deficit stood at 8.7% of GDP in June in cumulative 12-month terms, slightly more than 2 pp below the end-2020 figure (see Chart 1.9.1), while public debt stood at a still very high 123% of GDP in June. The deficit correction is explained by the pick-up in income (10.5% compared with the same period of the previous year) arising from the economic recovery under way, and by the moderation of expenditure growth, on the back of lower extraordinary expenses related to the response to COVID-19 (total expenditure remained constant compared with the same period of the previous year).

Bearing in mind these developments, the Banco de España's latest projections, published in September,[19] expect the general government deficit to improve significantly in 2021 and over the next two years (see Chart 1.9.2). After reaching 11% of GDP in 2020, the budget deficit could close 2021 around 7.6%. This forecast takes into account the measures adopted to temper the strong surge in electricity prices, and also the costs of a further extension, to the end of the year, of the COVID-19-related furlough schemes. The imbalance in public finances is expected to continue to correct in 2022 and 2023, thanks to the improved cyclical momentum expected and to the withdrawal of the extraordinary COVID-19-related measures.[20] Nevertheless, the deficit will still be above 3% of GDP in 2023 and public debt will decline by barely 5 pp over the projection horizon.

The structural deficit and debt levels envisaged for the end of the projection horizon (2021-2023) place Spanish public finances in a vulnerable position, which could also continue over longer horizons. In addition to the high level of public debt expected for 2023 (over 110% of GDP), the structural adjustment of Spanish

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18 See the INE's Household Budget Survey. Year 2020.

19 See Macroeconomic projections for the Spanish economy (2021-2023).

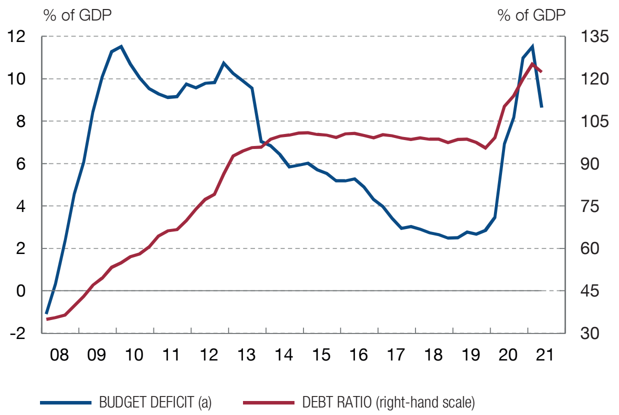
20 The draft 2022 State and Social Security Budget and the draft Budgetary Plan for 2022, which were presented after the cut-off date for the Banco de España's September projections, entail no significant change to the fiscal outlook for 2022.

Chart 1.9

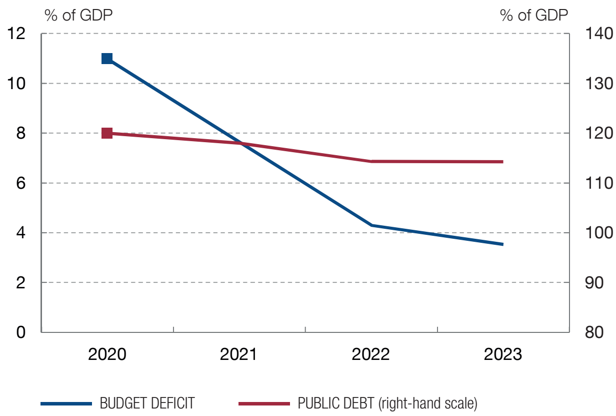
THE SPANISH BUDGET DEFICIT HAS DECLINED IN 2021, BUT IT REMAINS ABOVE ITS PRE-PANDEMIC LEVEL AND THE PROJECTED DEBT REDUCTION UP TO 2023 IS LIMITED

In the first half of 2021 the general government deficit declined, a process that is expected to continue during the rest of the year and over the next two years. However, if no new measures are introduced, the public debt and budget deficit levels expected for the end of the projection horizon will remain high, representing a source of vulnerability for the Spanish economy. This vulnerability is mitigated by low interest rate levels, which are reflected in reduced and declining cost of debt service. Although, in the short term, the expansionary fiscal policy should continue to help support the ongoing economic recovery, the need for a future credible and sustainable fiscal consolidation process advises that details of this process be defined and announced without delay.

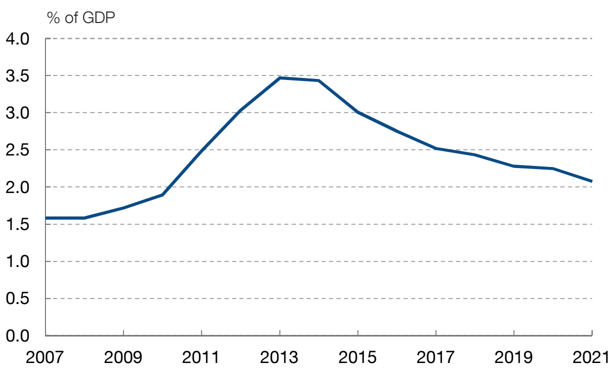
1 FINANCIAL POSITION OF GENERAL GOVERNMENT



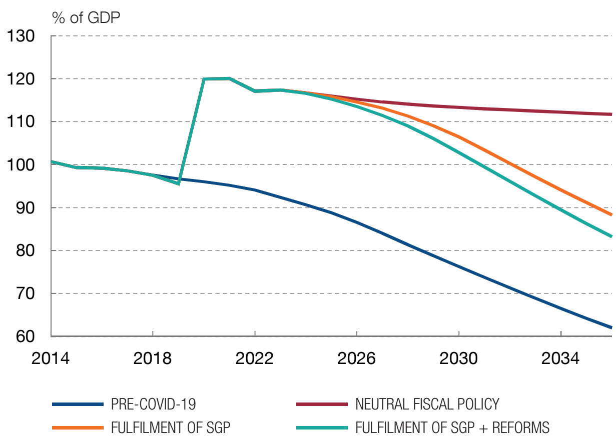
2 PUBLIC DEBT AND BUDGET DEFICIT FORECASTS (b)



3 INTEREST EXPENSES



4 SIMULATED PUBLIC DEBT PATHS (c)



SOURCES: Intervención General de la Administración del Estado (IGAE) and Banco de España.

a Four-quarter cumulative data.
b Banco de España macroeconomic projections published on 21 September 2021. The squares in 2020 denote the figure revised by the National Audit Office (IGAE) nine days later.
c The pre-COVID-19 scenario replicates the simulations of the public debt-to-GDP ratio made with data and projections at December 2019. The neutral fiscal policy scenario simulates the debt projections drawing on the Banco de España's latest forecasts (see Macroeconomic projections for the Spanish economy (2021-2023)), with no additional restrictions on the change in the structural balance. Fulfilment of the SGP scenario assumes a public debt consolidation plan with a reduction in the structural deficit, up to budgetary equilibrium, of 0.5 pp of GDP every year. The last scenario adds structural reforms that would lead to an increase in potential GDP of 0.6 pp in the long term.

public expenditure and revenue remains outstanding (over 3% of GDP), along with the challenges posed by population ageing. In the short and medium term, the monetary policy of the European Central Bank (ECB) and the economic growth momentum foreseeable as a result of the take-up of the NGEU funds are expected to help contain this vulnerability. So far, the impact of the rise in the debt ratio on interest expenses (see Chart 1.9.3) has also been mitigated by the low interest rates. However, a hypothetical future increase in interest rates would trigger a spike in interest expenses, adding pressure to the fiscal position, although this effect would not be immediate, given the maturities of the public debt. Moreover, an accommodative fiscal policy remains necessary to consolidate the economic recovery currently under way. In any event, this does not preclude the need for fiscal consolidation, to ensure that, in the medium term, the Spanish economy is in a better position to address the challenges outstanding, and in a less vulnerable position in the event of future adverse economic developments or a crisis of confidence. According to the simulation exercises performed, in the absence of budgetary consolidation measures the debt ratio would remain around 115% of GDP over the next fifteen years, under the assumption that the Spanish economy maintained growth rates similar to the average of recent decades. By contrast, fulfilment of the Stability and Growth Pact (SGP), especially if it is accompanied by structural reforms, would allow to reach over that period a lower level of indebtedness than that observed before the outbreak of the pandemic (see Chart 1.9.4).[21]

1.3.3 Financial flows vis-à-vis the rest of the world and the international investment position

In 2021 H1, and in contrast to 2020, international investors again made net purchases of Spanish general government debt, an indication that financial flows vis-à-vis the rest of the world were returning to normal. International investors' net purchases in 2021 H1 totalled €41.2 billion. In consequence, their holdings, which amount to around 45% of Spanish sovereign debt, ceased to fall as a proportion of the total (see Chart 1.10.1).

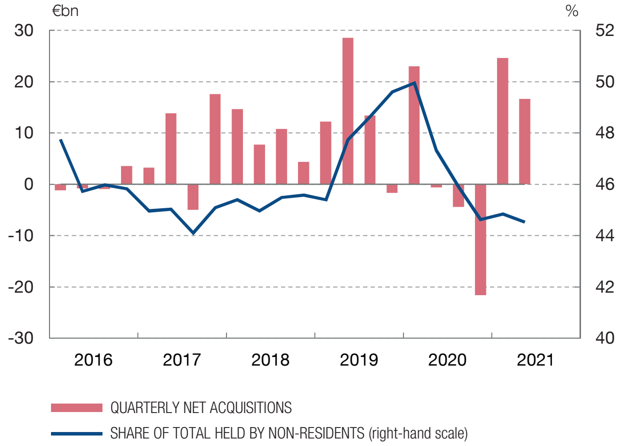
The Spanish economy's negative net international investment position (IIP) stood at 78.4% of GDP in June, representing an element of vulnerability in the event of deterioration of financing conditions in the international markets. Nevertheless, the ratio has fallen significantly since end-2020, specifically by 7.2 pp, of which 2.8 pp are explained by GDP growth. The valuation effects resulting from the increase in value of foreign assets held by Spanish residents and the decrease in value of Spanish liabilities held by international investors (see Chart 1.10.2) explains a further significant portion of this adjustment. In any event, this level of negative net IIP to GDP is still 3.4 pp higher than that existing at end-2019.

21 The SGP envisages a public finance adjustment that translates into an improvement in the structural balance of 0.5 pp of GDP per year until the level of this balance reaches zero. Furthermore, the debt rule requires that the excess of the debt-to-GDP ratio above the 60% benchmark be reduced by one twentieth per year. As the Spanish public debt ratio reached 120% of GDP in 2020, that excess is 60 pp. Therefore, according to the European rule, the debt ratio should be reduced, on average, by 3 pp per year.

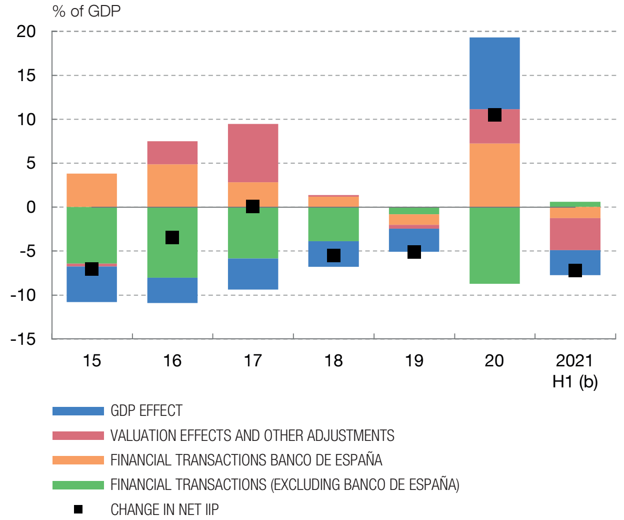
Chart 1.10
IN 2021 H1, INTERNATIONAL INVESTORS RETURNED TO THE SPANISH GOVERNMENT DEBT MARKET AND SPAIN'S NEGATIVE NET INTERNATIONAL INVESTMENT POSITION DECLINED

Non-resident sectors again made net purchases of Spanish general government debt in 2021 H1, an indication that financial flows vis-à-vis the rest of the world were returning to normal. In the same period, the Spanish economy's negative net international investment position (IIP) fell by 7.2 pp of GDP, thanks to positive valuation effects (due both to an increase in the value of foreign assets held by Spanish residents and a decrease in the value of Spanish liabilities held by foreign investors), net financial transactions vis-à-vis the rest of the world that were also positive (the counterpart of the current and capital account surpluses), and GDP growth.

1 INTERNATIONAL INVESTORS' NET ACQUISITIONS AND HOLDINGS OF SPANISH GENERAL GOVERNMENT DEBT



2 DETERMINANTS OF CHANGE IN NEGATIVE NET IIP (a)



SOURCE: Banco de España.

a The net IIP is the difference between the value of resident sectors' foreign assets and that of the liabilities to the rest of the world.
b Calculated on four-quarter cumulative GDP.

Spain's gross external debt rose by €66.4 billion in 2021 H1; although it fell to 197.9% of GDP thanks to output growth, it is still 28.4 pp above the pre-pandemic level. This high debt level is an element of vulnerability in the event of a possible tightening of financing conditions in the international markets. However, this vulnerability is mitigated, to a certain extent, by the debt composition, as slightly more than half is public sector debt (general government and Banco de España), and by the fact that the average repayment periods are lengthy and it is mostly euro-denominated debt.