

The macro-financial situation of the Spanish economy has continued to improve over the last six months. Activity has gradually recovered, thanks to the headway in the vaccination campaign and the effectiveness of the measures taken by the economic authorities to mitigate the impact of the pandemic. Both factors have prevented growth in non-performing loans in bank lending portfolios overall.

Nevertheless, close monitoring of the financial system must continue, as vulnerabilities remain high and there are risks that may hamper the economic and financial normalisation process.

Firstly, although most business sectors have returned to their pre-crisis turnover levels, the sectors most severely affected (for example, hospitality, transport, car manufacturing) have done so only incompletely, and they accumulate the highest increases in bank debt, and credit quality impairment. These sectors are also a source of potential latent impairment of bank loan portfolios. Although household income and employment levels have improved overall, lower income segments and those linked to sectors most severely affected by the crisis remain more vulnerable.

Moreover, the counterpoint to the necessary economic policy response to the pandemic has been a marked increase in public debt. This is a source of vulnerability for the Spanish economy, especially if financial conditions were to tighten. Accordingly, once the recovery has taken hold, a fiscal consolidation programme is needed, designed to lower debt levels and foster sustained and balanced growth.

A third vulnerability is linked to the banking system's low profitability. Although profitability returned to pre-pandemic levels in 2021 H1, underpinned by a significant decline in impairment charges, it is still below the levels in other countries and in many non-financial sectors.

In any event, compared with those performed last year, the banking sector stress tests reflect more moderate capital depletion in the face of an adverse scenario, albeit unevenly across banks. The distribution of the CET1 ratio between banks under this scenario does not indicate the need for extensive supervisory intervention were this scenario to materialise. Yet there are significant risks to the banking system, and part of the potential latent impairment of credit portfolios could materialise in the coming quarters. The banking sector has the capacity to absorb this shock, but adverse credit quality developments would reduce its ability to generate earnings and weaken its intermediation capacity, with a greater impact on banks with lower solvency levels.

In this setting, there are various risks facing the economic recovery, including a possible loss of confidence were the course of the pandemic to become less favourable, persistent global production chain bottlenecks, or higher inflation, particularly in energy goods. The factors behind the recent surge in inflation appear to be essentially temporary, so monetary policy should maintain its accommodative stance. Yet there is a risk that it may be some time before inflation normalises, which could prompt a tightening of financing conditions and could curtail the incipient recovery. Specifically, a premature withdrawal of the monetary stimulus measures, ahead of financial market expectations, could trigger such an adjustment process, giving rise to a sharp fall in financial asset prices. In addition, were the recovery to be checked, the credit quality of households and firms, especially those in the most vulnerable sectors, would decline and their non-performing exposures could increase. These risks to economic activity are particularly significant in the emerging market economies.

Regarding systemic financial risks, so far there are no signs of a build-up of risk requiring the activation of macroprudential tools. Economic activity has still not returned to its pre-pandemic levels, despite the support measures adopted, and in fact the orderly withdrawal of these measures poses a challenge in the short term. The expected normalisation of output over the coming quarters will help to close both the output gap and the credit-to-GDP gap, but this normalisation is subject to the risks identified.

Macroprudential policy has tightened in some other European countries, mainly owing to alarm signals in their real estate markets. In the case of Spain, the real estate cycle appears to be less advanced. At the aggregate level, housing shows no material signs of overvaluation and, although there has been strong growth in new mortgage lending in recent quarters, it started out from very low levels, the stock remains relatively stable and there has been no easing of credit standards. But this market must continue to be monitored, in view of the possibility that the recent momentum might develop into a sustained expansionary path.

Lastly, it is important to underline that the COVID-19 crisis has confirmed the need to address the structural challenges facing the banking sector and also other segments of the financial system: the generation of profitable business volume in a low interest rate environment, growing competition from technology firms, the increase in cyber risks and the potentially adverse effects associated with climate risks.

As regards the latter, this Financial Stability Report includes an initial – and still incomplete – assessment of the impact of the materialisation of climate change-related risks on the financial system. This is probably the most important challenge facing humanity in the coming decades. A preliminary conclusion is that these risks may have a significant impact on financial stability, through the materialisation both of the physical and the transition risks. The impact of the transition risks on banks'

solvency would be moderate in the short term, but they would put more pressure on profitability. Materialisation of the physical risks has very significant financial economic and financial impacts in the long term, in excess of those related to the transition costs. The analysis performed suggests that swift action is advisable to achieve an environmentally sustainable productive model that will not contribute to the materialisation of climate change.