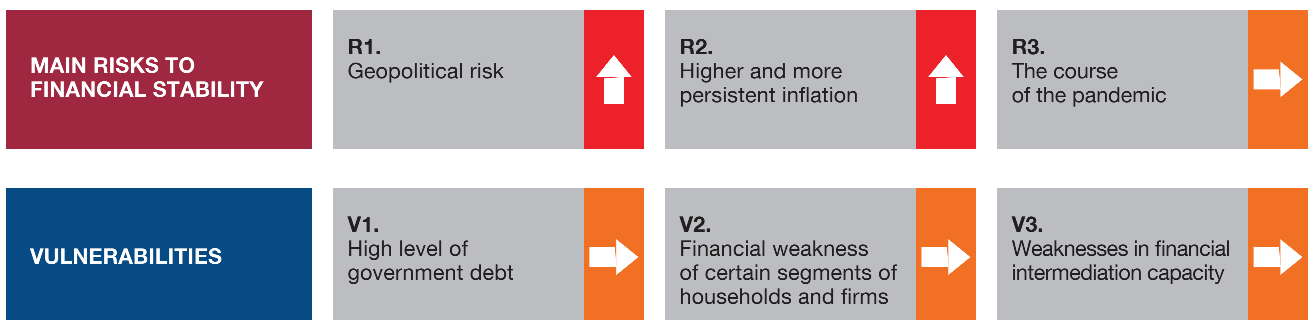
FINANCIAL STABILITY: MAIN VULNERABILITIES AND RISKS

More than two years after the onset of the economic crisis triggered by the outbreak of the COVID-19 pandemic, the world economy has been hit by the effects of the Russian army's invasion of Ukraine. The consequences of the invasion, albeit difficult to predict, will foreseeably be global and far-reaching, both geopolitically and from an economic and financial standpoint, and introduce new risks to financial stability (see Figure 1).

This new shock to the Spanish economy comes amid a gradual recovery, which remained incomplete, uneven across sectors and influenced by the course of the pandemic and continuous upside inflation surprises. However, the invasion of Ukraine and the western authorities' reaction, which have led to the imposition of unprecedented economic sanctions on Moscow, introduce a great level of uncertainty, with adverse consequences in terms of poorer economic performance and increased inflationary pressures, especially through energy and other commodity prices.

The Spanish financial sector faces this new shock having recovered its pre-pandemic profitability levels and with resilience generally remaining high. While Spanish banks have very limited direct financial exposure to Russia and Ukraine, the indirect effects of the new shock may be significant, particularly via the impact on those business sectors and population groups in which the post-pandemic recovery was slower or

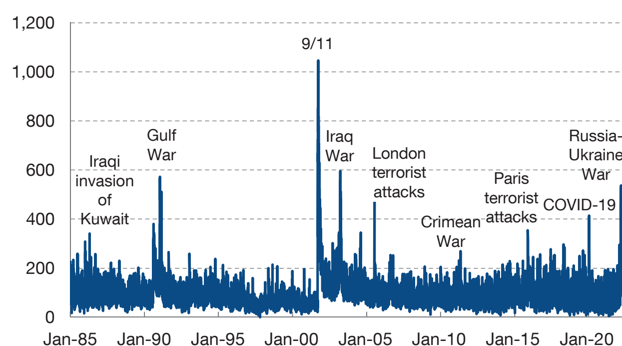
Figure 1
FINANCIAL STABILITY: MAIN VULNERABILITIES AND RISKS (a) (b)



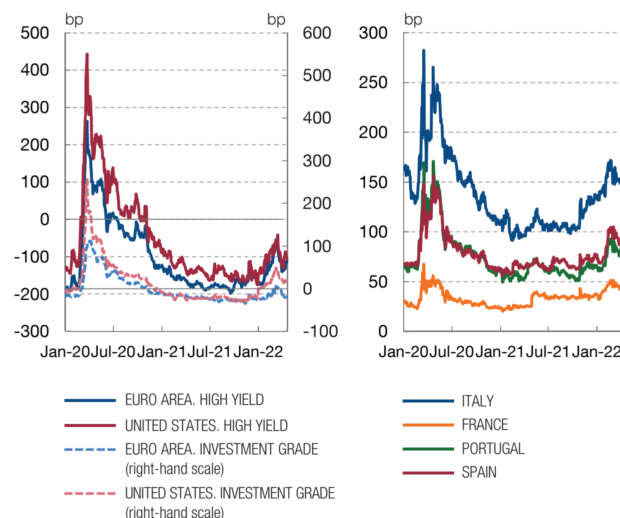
SOURCE: Banco de España.

a In this report, **the vulnerabilities** are defined as economic and financial conditions that increase the impact or probability of materialisation of **risks to financial stability,** which in turn are identified as adverse changes in economic and financial conditions, or in the physical or geopolitical environment, with an uncertain probability of occurrence, which hamper or impede financial intermediation, with negative consequences for real economic activity.
b The risks and vulnerabilities in this figure are measured using three colours: yellow (low level), orange (medium level) and red (high level). The arrows denote the change in the risks and vulnerabilities since the last FSR.

1 GEOPOLITICAL RISK



2 DEVIATIONS FROM THE HISTORICAL AVERAGE OF THE SPREADS OF NFCs' BONDS AGAINST THE SWAP CURVE (L-H PANEL) (a) AND 10-YEAR SOVEREIGN YIELD SPREAD AGAINST GERMANY (R-H PANEL)



SOURCES: Refinitiv Datastream and Banco de España.

a High yield: ICE Bank of America Merrill Lynch Non-Financial High Yield Index. Investment grade: ICE Bank of America Merrill Lynch Non-Financial Index. The deviations are calculated vis-à-vis the historical average between 1998 and 2022.

came later and which are also especially exposed to the economic consequences stemming from the invasion of Ukraine.

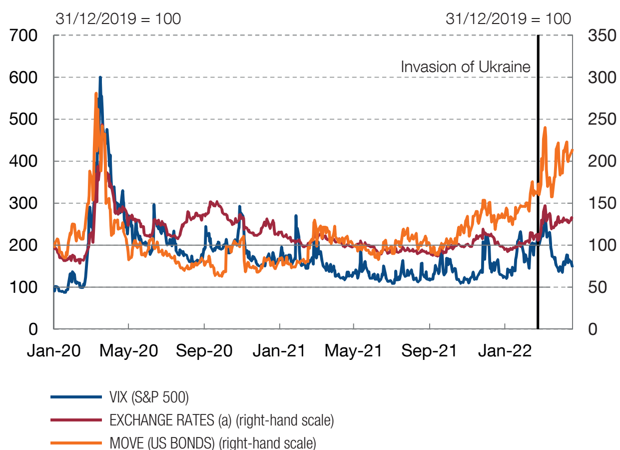
The main risks[1] to the stability of the Spanish financial system are discussed in greater detail below:

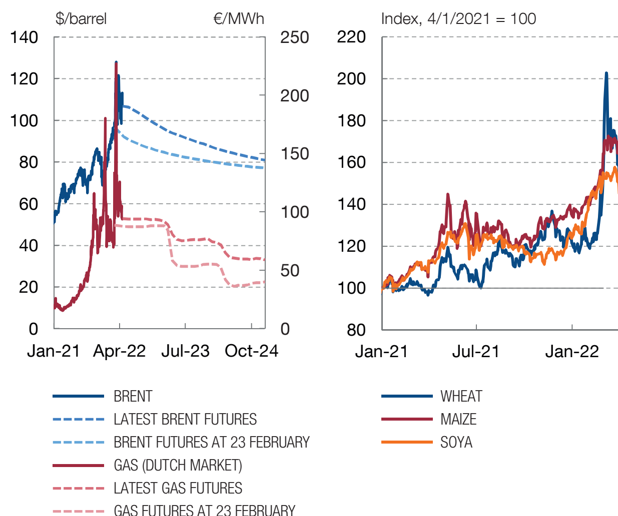
R1 Heightened geopolitical risks

The war between Russia and Ukraine has further strained global geopolitical tensions. The sanctions imposed on Russia by a large fraction of the international community in response to the invasion of Ukraine and Russia's response to those sanctions create a situation without precedent since the end of the Cold War, the severity and duration of which remain uncertain (see Chart 1).

On the financial markets, the higher uncertainty induced by the invasion could make investors more risk averse. This would drive up the premia associated with risky assets, although these have so far remained subdued (see Chart 2), and also lead to greater volatility (see Chart 3). The likelihood of certain events has increased, including further adverse corrections to risky asset prices, when there were already signs of overvaluation

1 Risks to financial stability are defined as adverse changes in economic and financial conditions, or in the physical or geopolitical environment, with an uncertain probability of occurrence, which hamper or impede financial intermediation, with negative consequences for real economic activity.





SOURCES: Refinitiv Datastream and and Banco de España.

a Average three-month volatility of USD/EUR, USD/GBP and JPY/USD.

in some assets and geographical areas before the conflict broke out, in addition to an increase in financial fragmentation and a deterioration in financing conditions.

The foreseeable decline in activity in Russia and Ukraine, together with greater uncertainty, also has an adverse impact on global trade and on households' and firms' confidence. As a result, they may postpone their consumption and investment decisions, which would contribute to weaker economic growth.

That said, the war's largest short and medium-term impact stems from Russia and Ukraine being major commodity producers: energy and metal commodities in the case of the former and agricultural commodities in the case of the latter. Europe is also particularly reliant on Russian oil and gas. Indeed, the war has already made energy prices skyrocket (see Chart 4). Against the pre-war background of high inflation, rising energy prices could compound inflationary pressures and dent activity. Possible disruptions to the transportation and supply of certain materials may also exacerbate the global value chain bottlenecks, compounding the downside risks to growth.

The Spanish economy and banks have very limited direct trade and financial exposures to Russia and Ukraine. This should mitigate the initial direct effects of the crisis. However, the indirect effects of the new shock, stemming from the impact on uncertainty, inflation and economic activity, may be significant.

Another consideration to bear in mind is that the current crisis will also significantly impact the financial and other sectors' operational risks, in light of the possible increase in cyber attacks.

R2 Higher and more persistent inflation

The Autumn 2021 FSR already signalled higher inflation rates worldwide, triggered by factors such as the spike in energy and food prices and the global supply chain disruptions, as being a risk factor. Since then, price rises have been higher and more persistent than expected, increasing the risk that they pose to economic activity and the maintenance of favourable financing conditions. Indeed, the main central banks have expressed their intention to adopt a less accommodative monetary policy to control this surge in inflation. In the short term, the combination of higher inflation, which erodes households' and firms' real income, and an increase in interest rates, could reduce these agents' ability to pay.

Due to its influence on global financing conditions, the comparatively swift and sharp expected tightening of monetary policy in the United States, where the steep upturn in inflation has partly fed through to monetary policy expectations, is especially significant. Inflationary pressures are also particularly high in some emerging market economies. This has led their central banks to tighten their monetary policy.

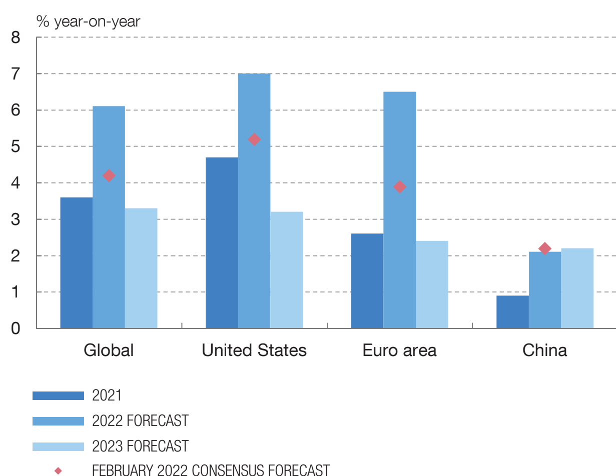
Inflation has risen dramatically in the euro area, but less so than in other economies, particularly the United States (see Chart 5), and the medium-term outlook remains anchored to the target of 2%. These developments, together with a slower recovery from the pandemic crisis in Europe and a greater expected impact of the invasion of Ukraine on activity in this geographical area, mean that the normalisation of ECB monetary policy, which is already under way, can be more gradual.

In the short term, however, the invasion of Ukraine is driving up inflation significantly and weakening growth, making monetary policy decision-making much more complex. In particular, while the moderation in economic activity stemming from the war could ease inflationary pressures in the medium term, the magnitude and persistence of the upturn in inflation already observed in the short term increase the risks of second-round effects on wages and on business margins materialising.

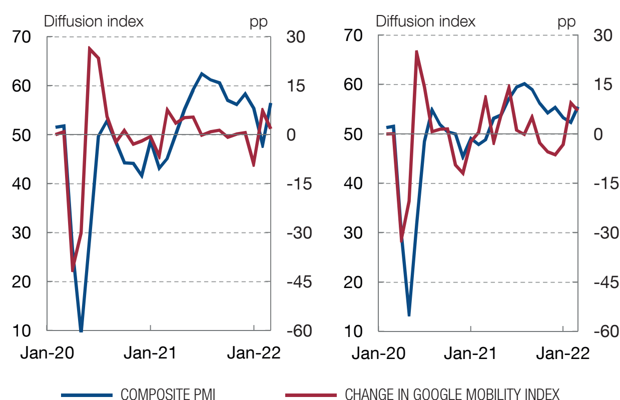
R3 The course of the pandemic

The progress made with vaccination programmes in 2021 boosted economic agents' confidence and facilitated the recovery in activity. However, the spread of the Delta variant (2021 Q2 and Q3) and the Omicron variant (2021 Q4) slowed the pace of this recovery around the world. In the case of Spain, the spike in infections in late 2021 and early 2022 adversely affected activity and employment, but its impact was smaller than in previous waves, due to less stringent restrictions on mobility and agents adapting to these adverse health conditions (see Chart 6).

5 INFLATION FORECASTS (2021-2023)
April 2022 Consensus Forecast



6 IMPACT OF THE PANDEMIC ON MOBILITY IN SPAIN (L-H PANEL) AND EUROPE (R-H PANEL)



SOURCE: Banco de España.

In any event, the pandemic has contributed to supply and demand mismatches in many countries' economies, and the restrictive "zero-COVID" policies imposed in certain geographical areas, such as China, may further disrupt activity, prolonging the bottlenecks that continue to affect global value chains. Against this backdrop, the possibility of new, more dangerous variants emerging that are capable of generating further waves of the epidemic with an adverse impact on economic growth lingers. However, the experience gained in prior waves would suggest that the economy is more practised at withstanding adverse epidemic developments. Also, some of the Spanish economy's structural characteristics could increase the relative impact compared with other countries should the COVID-19 pandemic take a turn for the worse. In this regard, the services sector's and, in particular, tourism's greater share of activity compared with other European countries, in addition to the greater importance of SMEs in the productive system, would be relevant.

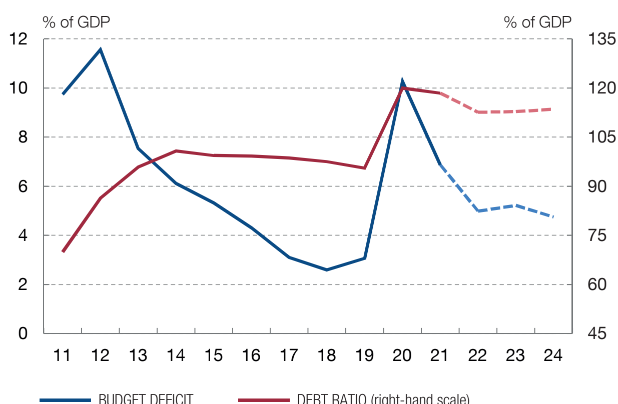
The main vulnerabilities[2] of the Spanish economy and financial system include:

V1 High level of government debt

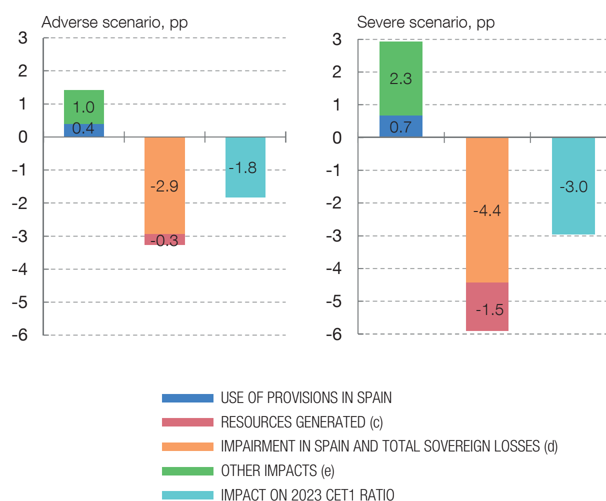
Despite falling by 1.6 percentage points (pp) in 2021, Spain's government debt-to-GDP ratio stands at very high levels and is roughly 20 pp higher than its pre-pandemic level. Meanwhile, the budget deficit fell by 3.4 pp in 2021, to reach 6.9% of GDP at the end of the year.

2 In this report, vulnerabilities are defined as economic and financial conditions that increase the impact or probability of materialisation of risks to financial stability

7 GENERAL GOVERNMENT FINANCIAL POSITION (a)



8 IMPACT ON THE BANK CET1 RATIO OF THE POTENTIAL MATERIALISATION OF RISKS IDENTIFIED FOLLOWING THE OUTBREAK OF THE WAR IN UKRAINE. CONSOLIDATED BUSINESS (b)



SOURCES: IGAE and Banco de España.

a For 2022-2024, the Banco de España's macroeconomic projections published on 5 April 2022 are used.
b Impacts are defined as changes in the expected CET1 ratio in 2023 and the different financial flows in 2023-2023 (i.e. generation of funds) that would result from the materialization of the negative variations of macro-financial conditions considered in the scenarios of Box 1.3.
c This variable includes net operating income in Spain and net profit attributable to business abroad. The aim is to compare the possible capital generation for the group of banks overall with impairment losses in Spain and the sovereign portfolio at consolidated level, which are the focus of these exercises.
d This variable represents the projected gross impairment losses in 2022-2023 of the private sector credit portfolio in Spain and other losses (associated with the debt securities portfolio, management of foreclosed assets and the sovereign portfolio).
e Other impacts include, among other effects, the change in RWAs between 2022 and 2023 and the effect of ICO guarantees.

In the short term, Russia's invasion of Ukraine may exert greater pressure on government spending to offset the temporary increase in energy and food prices and to reduce the reliance on foreign energy, thereby speeding up the green transition, which would also potentially be less orderly and costlier. In the medium and long term, greater government spending will be required to address the new European military defence needs.

The normalisation of monetary policy has already triggered an increase of over 150 basis points in the yields on the new 10-year Spanish government bonds issued since January 2021. Average costs, however, have continued to fall, as the bonds that are currently maturing were issued at higher yields. The relatively long maturities of Spain's sovereign debt are also a factor mitigating the immediate impact of this tightening of financing conditions on the interest burden.

Nevertheless, the high budget deficit and government debt levels render the Spanish economy vulnerable to the deterioration in financing conditions and limit the fiscal space to respond should fresh risks materialise (see Chart 7). Specifically, this vulnerability may become more evident amid the current high uncertainty, with potential bouts of risk aversion associated with a further deterioration in the geopolitical situation.

Against this background, a medium-term fiscal consolidation plan, which contains and reduces the vulnerabilities associated with high government debt levels, must be designed for implementation once the recovery has taken hold. This plan should detail the timeframes and measures necessary for achieving fiscal consolidation, with particular emphasis on the composition of the adjustment (revenue increases and expenditure cuts), which will be key to determining the plan's impact on economic growth. In addition, the fiscal stimulus measures should continue to be selective and target the most vulnerable agents bearing the brunt of the higher uncertainty and commodity prices. Structural reforms that improve the economy's potential growth should be a vital complement to this strategy.

V2 The financial weakness of certain segments of households and firms

2021 H2 saw a further recovery in corporate sector turnover and profitability figures, although these remain well below pre-pandemic levels in the sectors hardest hit by the COVID-19 crisis. Financing conditions held stable at favourable levels, thus easing liquidity risks and underpinning this sector's financial position.

However, it should first be noted that a large fraction of the State-backed loans extended in 2020 continue to benefit from grace periods. Most of these grace periods will come to an end before summer 2022, driving up the sector's debt burden and with it the possibility of latent impairment materialising in the stock of bank loans, particularly in the sectors most affected by the pandemic. Second, the adverse price developments in energy and other production inputs observed in recent months could impair the economic and financial situation of firms, particularly those that the health crisis has left in a more vulnerable position. The adoption of measures to alleviate the economic effects of the war in Ukraine, which include new government guarantee facilities and the extension of grace periods in the sectors hardest hit by the current crisis, could mitigate the deterioration in firms' financial position.

In the case of households, effective employment already exceeds pre-crisis levels and, on the information available up to 2021 Q3, aggregate net wealth has risen since the onset of the pandemic, easing concerns over their ability to meet their financial obligations.

However, the number of hours worked and average gross disposable income are still below pre-crisis levels. Likewise, lower-income households and those with close links to employment in the sectors hardest hit by the health crisis remain in a position of greater vulnerability. In addition, the effects of high inflation on economic activity and employment and the potential increase in financing costs could hamper the correction of the vulnerabilities observed in households' financial situation.

V3 Weaknesses in the financial intermediation capacity of the financial sector

The banking sector’s earnings for 2021 confirmed the recovery of their pre-crisis profitability levels observed in the H1 figures. The absence of any negative extraordinary items such as those recorded in 2020, the growth in net fee and commission income and the reduction in provisions for financial impairments contributed to this recovery. The positive contribution of profits from business abroad was also confirmed (and was larger than estimated at the onset of the pandemic), despite the high incidence of COVID-19 in some key regions for Spanish banks.

However, there are still latent credit portfolio impairments that could materialise over the coming quarters. Further, the possible worsening of the global macro-financial environment due to the flare-up in geopolitical tensions and rising inflationary pressures could drive up costs in terms of provisioning for such impairments, heightening the risks to banking sector profitability. In addition, the persistence of the current high level of uncertainty could drive up the financing costs of the banking sector.

Against this backdrop, banks must exercise considerable prudence, with suitable and timely recognition of the associated risks, in order to preserve confidence in the sector and support the continued flow of credit to the economy.

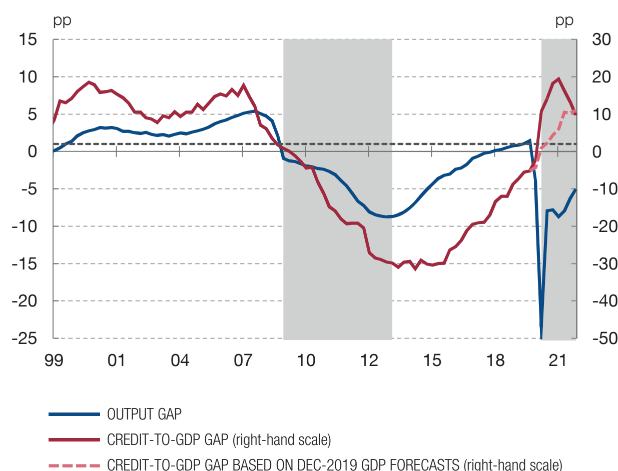
The stress tests conducted by the Banco de España, based on potential stress scenarios stemming from the current crisis, show that the sector’s aggregate solvency would hold at adequate levels (see Chart 8), with an uneven impact across banks.

As noted in previous FSRs, recent developments confirm the need to address the structural challenges that already faced the banking sector and other segments of the financial system. In particular, these include growing competition from tech firms and the crypto-asset boom (see the special chapter in this report), the increase in cyber risks (now exacerbated by geopolitical tensions) and the potential adverse effects associated with climate-related risks.

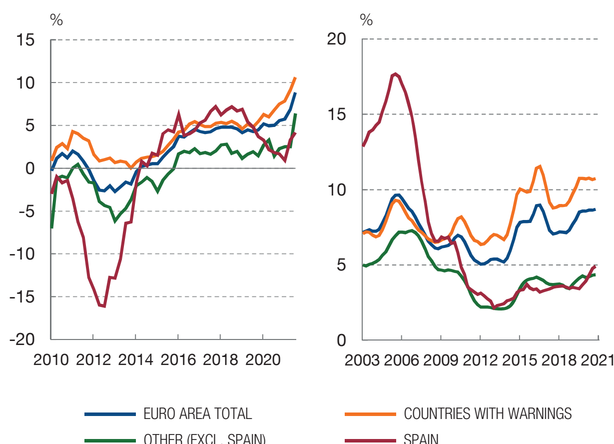
Macroprudential policy stance

From the macroprudential policy standpoint, the aforementioned heightened uncertainty and the absence of any indications of systemic financial imbalances building up in Spain make it advisable to maintain a loose stance at present. The output gap remains negative, key indicators of financial imbalances, such as the credit-to-GDP gap, are still conditioned by the sharp output decline in Spain in 2020 (see Chart 9), and growth in overall bank lending remains moderate, meaning the level of

9 CREDIT-TO-GDP GAP AND OUTPUT GAP (a) (b)



10 YEAR-ON-YEAR GROWTH RATE OF HOUSE PRICES (b) (L-H PANEL) AND THE RATIO OF NEW MORTGAGE LENDING TO GDP (R-H PANEL) (c)



SOURCES: INE and Banco de España.

a The shaded areas show the two periods of financial crisis identified in Spain since 2009. These correspond to a period of systemic banking crisis (2009 Q1-2013 Q4) and the crisis caused by COVID-19 (2020 Q1-2021 Q4). The output gap is the percentage difference between observed GDP and its potential quarterly value. Values calculated at constant 2010 prices. See P. Cuadrado and E. Moral-Benito (2016), "Potential growth of the Spanish economy", *Occasional Paper* No 1603, Banco de España. The credit-to-GDP gap is calculated as the difference in percentage points between the observed ratio and its long-term trend, calculated by applying a one-sided Hodrick-Prescott filter with a smoothing parameter equal to 25,000. This parameter is calibrated to fit the financial cycles observed in the past in Spain (see J. E. Galán (2019), "Measuring credit-to-GDP gaps. The Hodrick-Prescott filter revisited", *Occasional Paper* No 1906, Banco de España). Data available to December 2021. The dotted line represents a counterfactual credit-to-GDP gap, constructed using the Banco de España's 2019 GDP forecasts for the two subsequent years.

b The weight of the countries in the different groups is determined by their GDP.

c The ratio of new mortgage lending to GDP of each group is calculated as the ratio of new mortgage lending for all countries in each group (12-month cumulative) to GDP at current prices for that group (12-month cumulative).

the credit-to-GDP gap should not be interpreted as signalling a build-up of risk. Going forward, a gradual improvement in the output gap and a narrowing of the credit gap are expected, although the war poses downside risks to activity. In this setting of high uncertainty, a premature activation of macroprudential measures is to be avoided.

Nevertheless, if the credit-to-GDP gap holds at high levels against a backdrop of economic activity returning to a normal footing, or should clear signs of excessive credit growth in certain segments emerge, this would indicate the need for a more active macroprudential policy that provides the adequate incentives to build up additional loss-absorbing resources.

Macroprudential policy has been tightened in many European countries since the publication of the previous FSR, chiefly owing to warning signals in their real estate markets. House prices in the euro area as a whole are rising at their fastest pace since 2005. In some countries there are signs of these prices outstripping their long-run equilibrium value, while at the same time mortgage credit standards are deteriorating. In Spain, house prices rose sharply in 2021, with the correction that

followed the global financial crisis being reversed in recent years. However, these prices stand close to their long-run equilibrium value, meaning there are no clear indications of overvaluation as yet. Nonetheless, we must closely monitor developments in this market and the associated lending, with a view to identifying early any significant price imbalances or credit quality impairment that would require action being taken before risks materialise. In sum, we must remain watchful of developments in the Spanish real estate market.

A final reflection on the process of European integration

Lastly, like the pandemic crisis before it, the war has brought home the need to accelerate European integration. The financial arena is a cornerstone of that integration. Pan-European bond issuances to fund NGEU, and any other issuances as part of the response to the invasion of Ukraine, are an important step towards creating a European safe asset and a fiscal union, which would require establishing a permanent European fiscal stabiliser. In addition, deeper capital market integration in the euro area would pave the way for greater risk-sharing in the face of asymmetric shocks. The euro area's institutional architecture would also be enormously strengthened by the establishment of a European deposit insurance scheme and a common framework for resolving systemic crises.