1

RISKS LINKED TO THE MACRO-FINANCIAL ENVIRONMENT

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The first chapter of the FSR analyses the macro-financial environment of the Spanish economy in the recent period and that of the countries with which it shares the closest trade and financial ties, highlighting the most significant risks. These risks remain partially linked to the course of the pandemic, despite the vaccine roll-out having reduced the likelihood of the most adverse medium-term scenarios. However, the continuation of the pandemic into the quarters immediately following this publication increases the probability of more persistent effects on the financial capacity of households and firms, and on the productive system itself. Against this backdrop, an adequate economic policy response stands as the main mitigating factor. In the financial markets, prices of risk-bearing assets have risen in recent months, buoyed by an improving macroeconomic outlook following the emergence of effective vaccines against the coronavirus. However, high valuations for certain assets have generated some concern regarding the sustainability of these prices, particularly if less favourable macro-financial scenarios were to materialise. In the residential property market, sales have declined markedly relative to 2019, while prices have continued to show a degree of downward rigidity. Lastly, vulnerability has increased markedly due to the crisis weakening the financial position of the various non-financial sectors, particularly general government, while the deterioration in the private sector (households and firms) has focused on certain specific segments.

1.1 Macroeconomic environment

1.1.1 Systemic and materially important countries for the Spanish economy and banking system

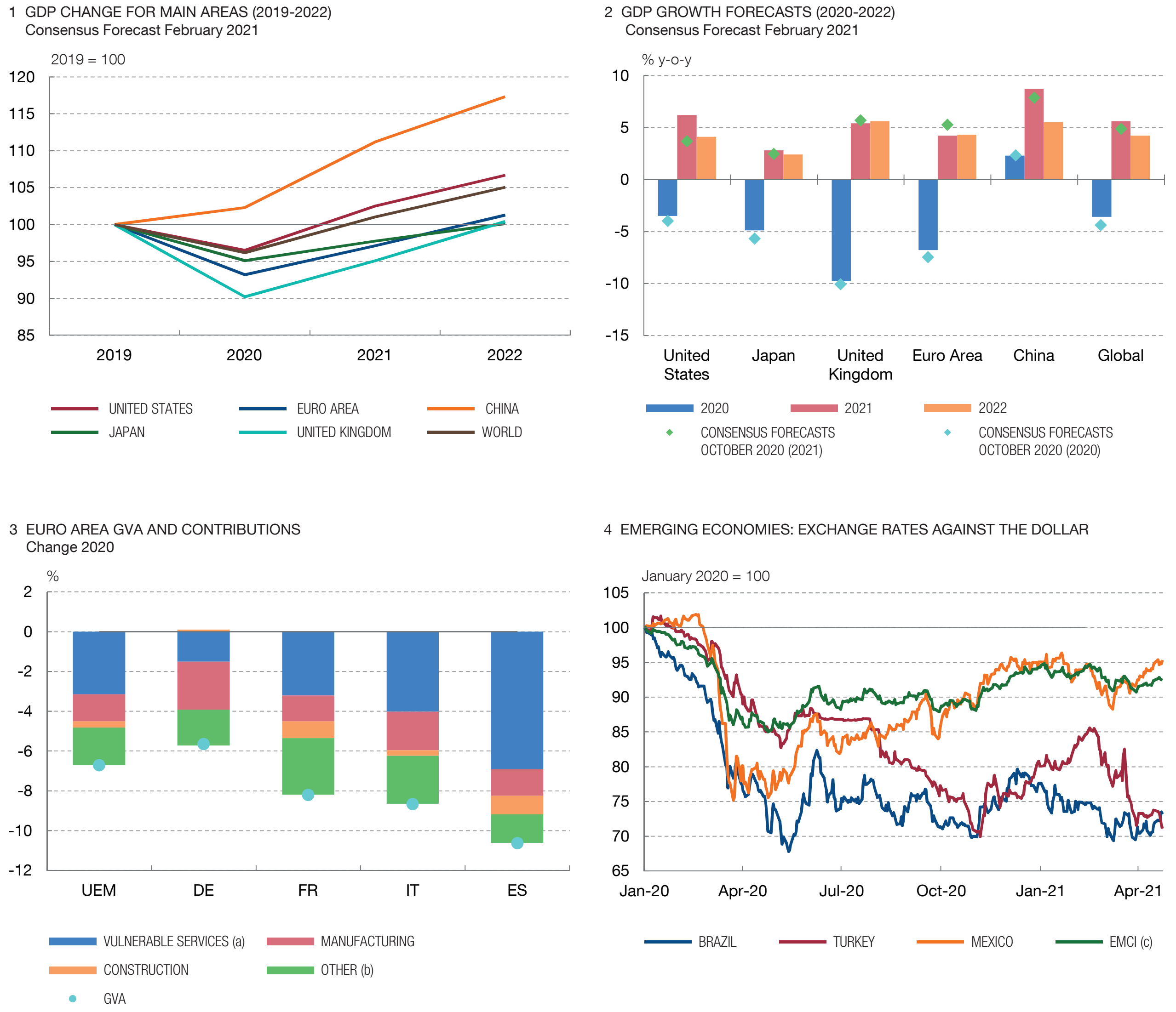
Global economic activity recovered in 2020 H2, but was adversely affected by the worsening of the pandemic from late 2020 onwards. Having slumped in 2020 H1, global activity surged in Q3 thanks to the easing of the containment measures and the support provided by economic policies. However, the recovery lost steam from the end of the last year, in the face of the worsening of the pandemic and the reintroduction of restrictions. The effect of the pandemic has been uneven across regions, owing to differences in how it has unfolded, the containment measures implemented, the degree of exposure to the hardest-hit sectors and the economic policies introduced. In 2020, world GDP declined by 3.3%, with marked regional differences (see Charts 1.1.1 and 1.1.2). Among the advanced economies, euro area GDP shrank by 6.7%, with the services sector being particularly affected[1]

[1] See A. L. Gómez and A. Río, (2021) “The uneven impact of the health crisis on the economies of the euro area in 2020”, Occasional Paper, Banco de España, forthcoming.

Chart 1.1

THE BASELINE SCENARIO OF A GRADUAL RECOVERY IN GLOBAL ECONOMIC ACTIVITY IN 2021-2022 IS GROUNDED ON EXPECTATIONS OF A DECLINING INCIDENCE OF COVID-19 AND THE ADEQUATE APPLICATION OF ECONOMIC POLICIES

The impact of the pandemic has been uneven across regions, shaped by the course of the pandemic, exposure to the most affected sectors (mainly the services sector) and the support measures provided in economic policies. The development of effective vaccines has improved the outlook, although the spread of variants of the virus represents a downside risk. Emerging financial markets registered a recovery in recent months, which was likewise reflected in exchange rate movements, which moderated from February onwards.



1 GDP CHANGE FOR MAIN AREAS (2019-2022)
Consensus Forecast February 2021

2 GDP GROWTH FORECASTS (2020-2022)
Consensus Forecast February 2021

3 EURO AREA GVA AND CONTRIBUTIONS
Change 2020

4 EMERGING ECONOMIES: EXCHANGE RATES AGAINST THE DOLLAR

SOURCES: Consensus Forecast, national statistics, Reuters and Eurostat.

a Vulnerable services include those most exposed to the containment measures (22.4% of total euro area GVA): wholesale and retail trade, transportation and hospitality (G-I) and artistic and entert. activities and other services (R-U).

b Other = primary (A); energy; non-market services (O-Q); other market services (communications; financial and insurance act., real estate act. and professional, scientific and auxiliary act.).

c Aggregate index of exchange rates of emerging market economies vis-à-vis the dollar. A fall means depreciation.

(see Chart 1.1.3). Spanish GDP declined by a notable 10.8%, while GDP in Germany fell by 5.3%. The contraction stood at 3.5% in the United States, 4.9% in Japan and 9.8% in the United Kingdom. Among the emerging economies, the most adverse effects were felt in Latin America, where GDP fell by 7% on average. By contrast, activity in China, the first economy to be affected by the pandemic, grew 2.3%.

The economic outlook has improved thanks to the availability of vaccines, but some uncertainty persists as to the course of the health situation and the intensity of the recovery. Following a weak start to 2021 due to the worsening of the pandemic, the recovery is expected to accelerate in H2 as those sectors that require greater social interaction are revived by progress in the vaccination programmes. Added to this would be the additional stimuli provided through economic policies, such as the extension of support measures for households and firms in most euro area countries and in the United States.[2] In Europe, plans to bolster the economy using funds from the Next Generation EU (NGEU) programme, which have yet to be determined, will prove most effective if the funds are allocated to high value-added investments and are supplemented by reforms to strengthen potential growth. The analysts' consensus expects the world economy to grow at a rate close to 6% in 2021 and above 4% in 2022 (see Chart 1.1.2). The consensus figures for the euro area, which are in line with those of the ECB's March projection exercise, forecast GDP growth of around 4% in both years, meaning pre-pandemic activity levels would not be reached until 2022 H2.

In the near term, the risks for the world economy remain associated with the pandemic and in particular with the headway made in the vaccination programme. Looking ahead, there is still a risk that solvency problems will emerge for non-financial corporations after the crisis. The downside risks revolve, first, around the spread of new and more resistant variants of the virus or a delay in the vaccination process, which may lead to fresh social distancing measures. Second, insufficient support from economic policies, or the premature withdrawal thereof, could result in solvency problems for businesses. Likewise, the potential spillover effects of an increase in long-term interest rates in the United States, against the backdrop of the impact had by fiscal expansion on activity and inflation in this country, could lead to a tightening of financial conditions in other economic areas that are in a different cyclical position. Lastly, high government and private indebtedness could curtail spending and hinder the recovery process. On the positive side, the outlook could be improved by more favourable progress in the vaccination programme. Meanwhile, the possibility of a no-deal Brexit, which was among the risks identified in the previous FSR, has faded thanks to the withdrawal agreement between the United Kingdom and the European Union.

The main emerging economies where Spanish banks have a significant presence[3] likewise recorded a recovery in 2020 H2, which lost momentum in early 2021. Broadly speaking, emerging markets recovered much of the losses

[2] See Box 3 "Analysis of US fiscal policy plans", *Quarterly Report on the Spanish Economy 2021 Q1.*

[3] Each year the Banco de España identifies a list of non-EU/EEA countries (third countries) that are materially significant for the Spanish banking system, based on the volume and weight of the Spanish banking system's international exposures. This exercise is conducted pursuant to the recommendations of the European Systemic Risk Board (ESRB). In 2020, six emerging countries were identified in this category: Mexico, Brazil, Turkey, Chile, Peru and Colombia.

registered from March 2020. Capital inflows increased from November onwards and, in some segments and regions, offset the outflows recorded in the first months of 2020. However, several of these countries have recently seen long-term interest rates increase, as a result of rising long-term interest rates in advanced economies, and currency depreciation. Financial conditions and capital flows towards emerging economies may be adversely affected if these trends continue going forward. In this regard, the main emerging countries in terms of Spanish banking exposures find themselves affected both by pandemic-related risks and those relating to macro-financial imbalances:

— In Mexico, GDP fell by 8.5% in 2020, more than the Latin American average, partly owing to less fiscal stimulus,[4] greater exposure to tourism and the sharp decline in the US manufacturing sector in the early stages of the pandemic.[5] The Mexican economy is also exposed to a potential tightening of global financial conditions, along with local factors such as uncertainty stemming from proposed reforms to the energy sector[6] and to the Banco de México Law.[7] These could undermine investor confidence and the country's credit rating, which remains adversely affected by the PEMEX situation. On the positive side, Mexico may be among the economies to benefit most from the fiscal stimulus in the United States via its trade and remittances channels.

— In Brazil, by contrast, GDP fell by a more moderate 4.1%, owing to less stringent restrictions on movement and sizeable monetary, and particularly fiscal, support. The outlook for 2021, however, is less auspicious, since much of the credit support programmes and fiscal stimuli, particularly transfers to households, have expired[8] and a monetary tightening has begun, which is discounted to last until 2022. The weaker relative performance of the Brazilian real is also a reflection of the continuing political tensions over the reforms and fiscal adjustment needed to tackle the high level of government debt (see Chart 1.1.4).

— Turkey was one of the few countries to record GDP growth in 2020 (1.8%), thanks in part to the support measures introduced, particularly for credit.

[4] See the IMF policy response tracker: *Policy Responses to COVID-19.*

[5] See Banco de España (2020), *Report on the Latin American economy. First half of 2020,* for a description of the pandemic transmission channels in the region.

[6] On 1 February 2021, the Mexican government submitted a bill to reform Mexico's Electricity Industry Law, with the aim of changing the order in which electricity is dispatched to the national grid to favour the State-owned utility company (Comisión Nacional de Electricidad) over private sector firms. The reform may contravene the free trade agreement with the United States and Canada (USMCA).

[7] In December 2020, the Mexican Senate passed a bill to amend the Banco de México Law. The amendment would force the central bank to buy foreign currencies that commercial banks are unable to put into the financial system. The central bank has argued that the reform would jeopardise its reputation and independence.

[8] The Brazilian government did not reintroduce transfers to households that expired at the end of 2020 (4.4% of GDP), and replaced them with an income support program of a much lower amount (0.6% of GDP).

However, these stimuli exacerbated the country’s macro-financial imbalances, such as high inflation and reliance on external financing. This has been reflected in the depreciation of the lira and diminishing reserves, leaving the country considerably vulnerable to a tightening of global financial conditions. Against this backdrop, the Turkish central bank shifted towards a more restrictive monetary policy (see Chart 1.1.4) so as to keep inflation and depreciation pressures in check.[9] More recently, the dismissal of the head of the country’s central bank triggered a further sharp depreciation of the lira and capital outflows, resulting in significant financial turmoil.

1.1.2 Spain

As in the rest of the world, the developments in the Spanish economy since the spring of 2020 have been entirely conditioned by COVID-19. In 2020, Spanish GDP registered an annual average contraction of -10.8%, the steepest drop in recent history. The impact was concentrated in H1, followed by an incipient recovery from Q3 onwards (see Chart 1.2). During this period, private consumption and investment were severely weighed down by the drop in income, heightened uncertainty and the restrictions to contain the pandemic. Foreign trade flows have also plunged, leading the external balance to make a net negative contribution to GDP growth in real terms. The decline in tourism exports has been particularly severe, heavily affected by the restrictions on international travel.

The upturn in activity was robust in 2020 Q3, but ground to a halt in Q4 as a result of adverse epidemiological developments. In any event, the recovery has been only partial thus far. Reduced control over the spread of the virus during the winter months negatively affected the confidence of households and firms, with the attendant adverse bearing on aggregate demand, and led to more stringent restrictions on mobility and economic activity,[10] with additional negative effects. However, these had a far smaller impact on GDP than in Q2, thanks to economic agents adapting to the new environment. Nevertheless, at the turn of the year Spain was still among the economies hardest hit by the pandemic, with quarterly GDP in 2020 Q4 down 8.9% on pre-crisis levels, while that gap for the euro area as a whole stood at more than 4% (see Chart 1.2).

In the near term, economic activity growth is expected to be modest until the population has been immunised. Under the baseline scenario of the Banco de España’s most recent projections, GDP would grow robustly in 2021 H2 thanks to

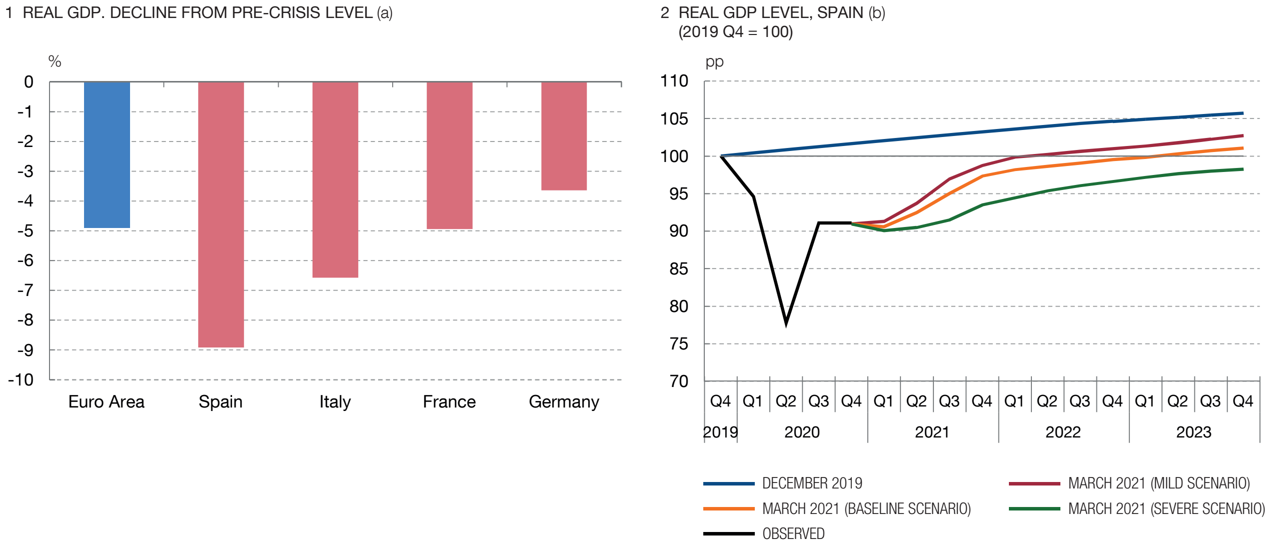
[9] In addition, the Turkish central bank and banking supervisory authority began to unwind the stimulus measures for lending.

[10] See Ghirelli, Gonzalez, Herrera and Hurtado, “Weather, mobility and the evolution of the COVID-19 pandemic”, *Working Paper* No 2109, Banco de España.

Chart 1.2

AMONG THE EUROPEAN COUNTRIES, THE PANDEMIC HAS HAD A PARTICULARLY SEVERE IMPACT ON SPAIN'S GDP, WHICH UNDER THE BASELINE SCENARIO WOULD RECOVER PRE-CRISIS LEVELS IN 2023

Spanish GDP declined 10.8% year-on-year in 2020, the sharpest drop in its recent history and larger than that of comparable European countries. The impact was concentrated in H1, with an incipient, albeit incomplete, recovery as of Q3. Thus, in the last quarter of 2020, economic activity in Spain stood considerably below pre-pandemic levels (-8.9%). Under the baseline scenario of the projections, based on the gradual disappearance of the pandemic's adverse economic effects, Spain would recover the GDP level observed prior to the onset of the crisis in 2023 H2. As a result of the uncertainty as to precisely how the health situation will unfold and the degree of permanence of the economic impacts felt in 2020, additional scenarios have been considered, generating a range of possible GDP trajectories around the baseline projection.



1 REAL GDP. DECLINE FROM PRE-CRISIS LEVEL (a)

2 REAL GDP LEVEL, SPAIN (b)
(2019 Q4 = 100)

SOURCES: Eurostat and Banco de España.

a GDP year-on-year change in 2020 Q4.

b A baseline scenario and two alternative scenarios (mild and severe) are projected for the Spanish economy. These alternative scenarios differ from the baseline scenario in terms of the course of the pandemic and the medium-term consequences thereof. For more infomation, please see March 2021 Macroeconomic Projections in Spain 2021-2023.

headway in the vaccination process, the use of NGEU funds[11] and the international economic performance. Spanish GDP would grow by 6% in 2021 under this baseline scenario, with the recovery in activity continuing in 2022 and 2023 (see Chart 1.2.2).

However, owing to the very high level of uncertainty, two alternative scenarios were envisaged. Uncertainty regarding the duration of the health crisis appears to have diminished given the anticipated progress in the vaccination process. Nonetheless, doubts persist regarding the extent of the pandemic's potential negative economic effects beyond the short term, which is not entirely unconnected with the duration of the pandemic itself. Resolute and coordinated action through economic policy, providing private agents with income and liquidity, has been a key factor in limiting the damage to the productive system. However, it will not succeed

[11] See Box 1 "Macroeconomic projections for the Spanish economy (2021-2023)", *Quarterly report on the Spanish economy* March 2021.

in preventing such damage altogether, particularly if the health crisis persists for an extended period of time. The scenarios also differ in another respect: the degree of persistence of the behavioural changes prompted by COVID-19 among economic agents. To this end, different assumptions were considered regarding household spending decisions in Spain and the rest of the world (through tourism exports).

The additional risks for the baseline scenario include more adverse epidemiological developments (particularly in the near term), uncertainty over the resilience of households, and the scale of the incipient structural changes that the pandemic may have accelerated. First, potential epidemiological developments that are more adverse than anticipated (for instance, relating to new, more contagious and more vaccine-resistant strains of the virus) could jeopardise the pace of the recovery in 2021, owing to their direct negative effects on aggregate demand as a result of impaired confidence and the need to introduce more stringent restrictions on movement. Second, despite the forcefulness of the measures introduced (particularly the schemes to preserve employment in the near term and to provide liquidity to firms, added to which would be the impact of the NGEU programme in 2021), the prolongation of the health crisis increases the likelihood of a downturn in the labour market and of rising business insolvencies, causing persistent damage to the productive system. A further source of uncertainty is the pandemic accelerating certain pre-existing structural transformation processes, such as digitalisation, which would require a reallocation of economic resources of an unknown magnitude.

1.2 Financial markets and the real estate sector

1.2.1 Financial markets

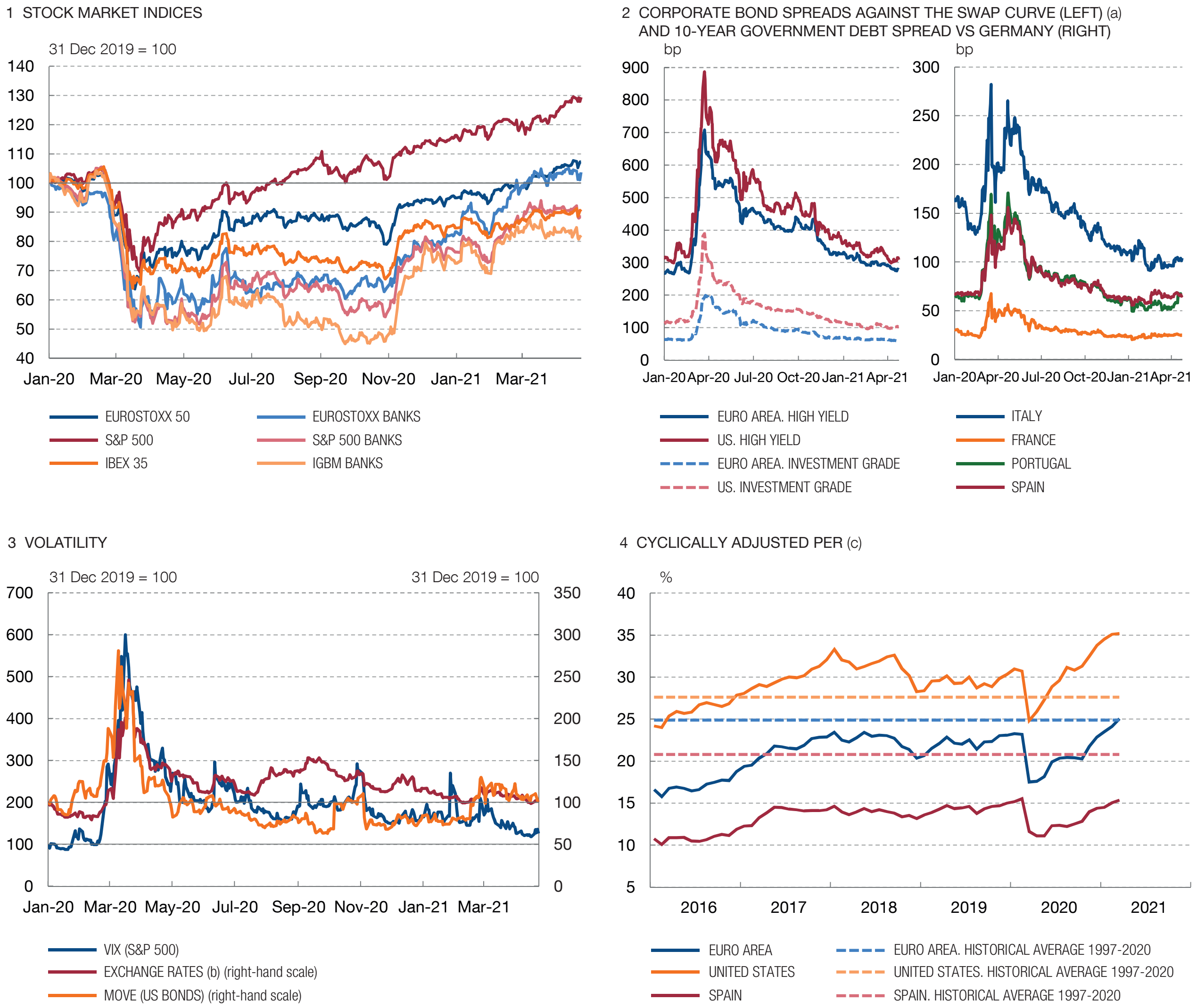
Since the cut-off date of the last FSR, the development of effective vaccines against COVID-19 and progress in the vaccination process on a global scale have driven price gains for risk-bearing assets on international financial markets, despite the new waves of the virus that were exacerbated by the emergence of new strains. Following the uptick in risk aversion in late October, triggered by the worsening of the pandemic in Europe and uncertainty over the outcome of the presidential elections in the United States, the publication of data on vaccine effectiveness in early Novermber and, since the beginning of this year, the progress of the vaccination campaign have generated optimism among investors. This has been reflected in gains on stock market indices, declining credit risk premia and a decrease in asset price volatility, likewise supported by the elimination of other risk scenarios, such as the United Kingdom withdrawing from the European Union without an agreement[12] (see Charts 1.3.1, 1.3.2 and 1.3.3).

[12] There was sporadic volatility increase on the S&P 500 (VIX) index towards the end of January, linked to coordinated transactions by retail investors; since mid-February, volatility increased on US sovereign bond options (MOVE) owing to steepening at the long end of the yield curve.

Chart 1.3

MEDICAL ADVANCES AGAINST COVID-19 HAVE FAVOURED THE REVALUATION OF RISK-BEARING ASSETS IN RECENT MONTHS, ALTHOUGH DOUBTS HAVE BEEN RAISED OVER THEIR SUSTAINABILITY IN SOME CASES

The development of effective vaccines against COVID-19 and progress in their distribution have generated optimism among investors, which has been reflected by rising stock market indices, declining credit risk premiums and narrowing sovereign debt spreads in the euro area, along with lower volatility for asset prices. Rising equity prices have lifted US stock markets to very high levels relative to the companies' cyclically adjusted earnings.



1 STOCK MARKET INDICES

2 CORPORATE BOND SPREADS AGAINST THE SWAP CURVE (LEFT) (a) AND 10-YEAR GOVERNMENT DEBT SPREAD VS GERMANY (RIGHT)

3 VOLATILITY

4 CYCLICALLY ADJUSTED PER (c)

SOURCES: Robert J. Shiller and Thomson Reuters Datastream.

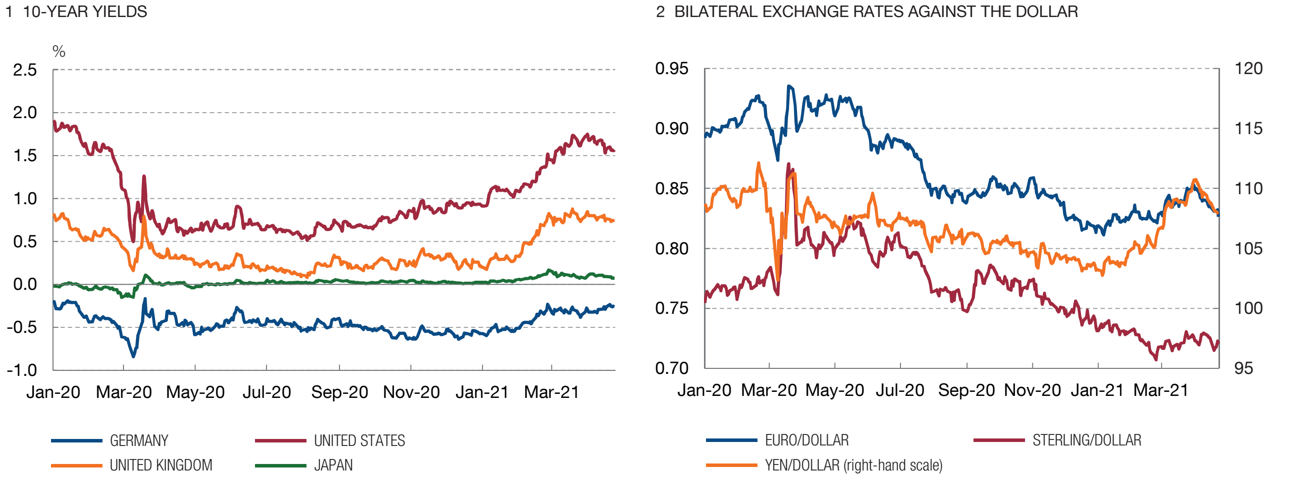
a High yield: ICE Bank of America Merrill Lynch High Yield index. Investment grade: ICE Bank of America Merrill Lynch Corporate index.
b Average three-month volatility of USD/EUR, USD/GBP and JPY/USD.
c The cyclically adjusted PER is calculated as the ratio between the share price and the 10-year moving average for earnings.

Long-term yields on higher-rated sovereign debt have risen in the year to date, particularly in the United States. These developments have been shaped by lower risk aversion, more favourable economic expectations, an increase in expected inflation and fiscal spending packages, which will require new issuances by treasuries. Because these act as safe-haven assets, the returns demanded on them declined significantly during the height of the uncertainty at the onset of the

Chart 1.4

LONG-TERM YIELDS HAVE RISEN FOR HIGHER-RATED SOVEREIGN BONDS AND THE US DOLLAR HAS CEASED ITS DEPRECIATION SINCE THE TURN OF THE YEAR

The long-term yields of higher-rated sovereign bonds have risen, especially in the United States and the United Kingdom, shaped by lower risk aversion, more favourable economic expectations, an increase in expected inflation and the fiscal spending packages. Lower risk aversion has also helped the US dollar to continue its depreciation in the final stages of 2020, although that trend seems to have reversed since the start of 2021 owing to improved economic recovery expectations in the United States.



SOURCE: Thomson Reuters Datastream.

pandemic. With the exception of Japan, these yields remain below the levels observed in early 2020 (see Chart 1.4.1). This lower risk aversion has also been conducive to the sustained depreciation of the US dollar, which also acts as a safe-haven asset, although that trend looks to be reversing this year due to better expectations for economic recovery in the United States (see Chart 1.4.2).

In euro area sovereign bond markets, long-term yield spreads between countries have continued at reduced levels in the first quarter of 2021. This has been driven by the ECB purchase programmes, particularly the PEPP (which was extended in December following the recalibration of monetary policy instruments), and by the agreement on the EU's recovery fund (see Chart 1.3.2).

In the final stretch of 2020, the strongest gains on stock market indices came in those sectors that had experienced the largest losses since the onset of the pandemic. Accordingly, prices in the banking sector have accumulated stronger gains since early November than other sectors, such as telecommunications or technology. In keeping with these developments, and as a consequence of the different sectoral composition of the stock markets, European indices, particularly the IBEX 35, have posted more robust gains than the S&P 500.[13] However, the indices of more cyclical sectors (including the banking index) and some of the

[13] In particular, the banking sector has a weight of approximately 5% on the S&P 500, 6% on the EURO STOXX 50 and 22% on the IBEX 35, while the weight of the technology sector is 28%, 13% and 6%, respectively.

European overall indices remain below pre-crisis levels. By contrast, the US index has reached all-time highs (see Chart 1.3.1).

In recent months, corporate credit risk premia have declined more sharply in the high-yield segment than in the investment-grade segment, all the segments now standing close to pre-pandemic levels. This performance appears to have been underpinned by central banks' asset purchase programmes and by lower risk aversion (see Chart 1.3.2). In the United States, where the central bank includes investment-grade and high-yield bonds in its purchase programme, issuances of both types of instrument ended 2020 at record highs, while in the euro area and Spain this was only true of the investment-grade segment. Since the beginning of 2021, US and euro area issuances in the high-yield segment already exceed those of previous years.

The number of corporate bond credit rating downgrades has declined significantly in recent months, although a slight rebound was observed in March. This reduction has also been observed in the case of Spanish companies. Since the onset of the crisis, the cumulative number of downgrades worldwide and in the euro area is lower than that observed in the equivalent period following the collapse of Lehman Brothers in September 2008. Nonetheless, a notable proportion of issuances with BBB rating continues to have a negative outlook.

The rapid recovery in the prices of risk-bearing assets in certain segments has raised concerns regarding their sustainability, particularly if certain risks materialise. Price corrections could be triggered for some assets – particularly those with the most evident signs of high valuations – by a worsening of the epidemiological situation, a downward revision of corporate earnings expectations or a premature withdrawal of State support measures. In particular, the cyclically adjusted price-to-earnings ratio (PER) of S&P 500 firms is currently high, standing above its historical average. This is largely due to the price performance of a handful of large firms, particularly in the technology sector. By contrast, equity prices in the euro area and Spain do not appear high compared to the cyclically adjusted earnings of the listed companies (see Chart 1.3.4). The credit risk premia on corporate debt markets are low relative to the historical relationship with their fundamentals, particularly in the high-yield segment, which may be linked, among other factors, to the effect of asset purchase programmes run by central banks (see Box 1.1).

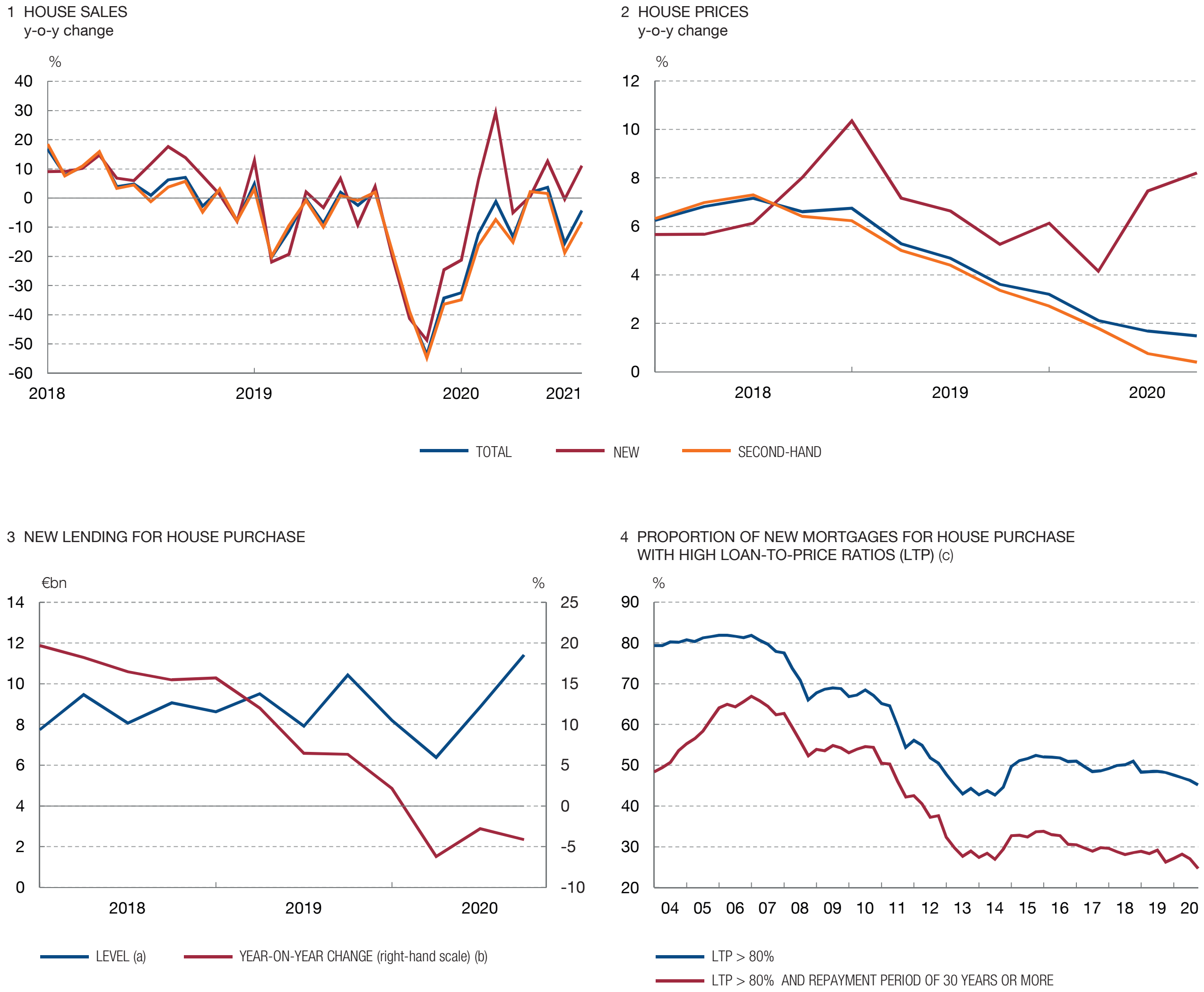
1.2.2 The real estate market in Spain

House sales fell by 17.7% in 2020, weighed down by a sharp fall-off during the initial months of the pandemic. Following the stringent lockdown last spring, house sales began a gradual recovery trajectory that extended until the end of the year, underpinned by the release of the demand that was pent up during the first

Chart 1.5

PROPERTY TRANSACTIONS HAVE BEEN IMPACTED BY THE COURSE OF THE PANDEMIC, AS HAS NEW LENDING FOR ITS PURCHASE, WHILE PRICES HAVE CONTINUED TO DECELERATE

House sales ended 2020 with a negative balance, weighed down by the slump in transactions during the early months of the pandemic. Despite this context, house prices did not record widespread declines, but rather continued the pre-existing slowdown. The new housing segment registered a more favourable trend, which may reflect a certain shift in the preferences of agents. New lending for house purchase recovered significantly in 2020 H2, partially offsetting the decline recorded during the spring lockdown. Lending standards for new mortgages appear to have tightened slightly in recent quarters.



SOURCES: INE, Colegio de Registradores and Banco de España.

a Cumulative three-month data.
b Quarterly data. Four-quarter average.
c The loan-to-value data are incomplete and relate to a sample.

wave of COVID-19. This upward trajectory in transactions in 2020 H2 did not continue into early 2021; sales declined year-on-year in January and February (see Chart 1.5). The less favourable developments in transactions in the first two months of the year were concentrated in the second-hand housing and the multi-family housing segments. By regions, this reduced buoyancy was largely seen in the regions that tend to present higher transaction volumes. Meanwhile, sales of new or single-family homes have demonstrated greater resilience since the start of the recovery than those of second-hand or multi-family housing. This pattern could continue if the apparent shift in buyer preferences – towards larger homes with open spaces and located in peripheral areas of cities – takes root, insofar as new or single-family housing is able to adapt flexibly to these changes.

House prices continued the trend slowdown that began prior to the pandemic, with no across-the-board declines observed thus far. The house price index rose 1.5% year-on-year in 2020 Q4, with a notable acceleration in new-build prices (8.2%), which may, at least in part, reflect investment decisions taken before the crisis as well as the above-mentioned shift in demand trends (see Chart 1.5.2). By contrast, second-hand house prices continued to slow (0.4%). The resilience of residential property prices to date stands in contrast to the sharp declines observed during the global financial crisis. Several factors are behind this. First, the current crisis was not prompted by an oversized real estate sector or the financial excesses thereof. Further, forced property sales have so far been kept in check thanks to the introduction of income protection mechanisms – such as mortgage moratoria and furlough schemes – for those households most affected by the crisis, together with the far more stringent credit standards for house purchase in recent years and lower levels of indebtedness. Lastly, prior to the onset of the pandemic there were no clear widespread signs of property market overvaluation. The future evolution of house prices is also affected by the uncertainty about the intensity of the recovery in economic activity.

In the real estate credit market, new loans for house purchase have also recovered somewhat, while credit standards appear to have tightened slightly. 2020 H2 saw a significant recovery in the volume of mortgage loans for house purchase, which helped to partially offset the heavy fall-off in such lending in the months following the outbreak of the pandemic (see Chart 1.5.3). However, this performance has been accompanied by a slight tightening of credit standards. Accordingly, the proportion of new loans with a loan-to-price ratio (LTP) of over 80% has declined (see Chart 1.5.4). Among these, the share of mortgages with long repayment periods has decreased. Moreover, the interest rate spread against the risk-free reference rate held practically unchanged in 2020. These developments suggest that institutions remain somewhat cautious when it comes to granting such credit.

The crisis has affected the commercial real estate market more acutely than the residential market, which is consistent with its greater sensitivity to the business cycle and changes vis-à-vis commercial distribution channels, with online sales accounting for a larger share. The number of transactions has plunged and prices have declined across the board, albeit moderately. Against this backdrop, new mortgages secured by commercial real estate show no sign of recovery and credit standards have tightened. This is reflected in, for instance, the decline in the share of mortgages with a high LTP ratio.

1.3 The non-financial sectors

1.3.1 Non-financial corporations and households

The COVID-19 crisis is having a severe impact on corporate earnings. On the information available for the sample of firms contributing to the Central Balance Sheet Data Office Quarterly Survey (CBQ), which are predominantly large firms, the percentage of companies with a negative ROA[14] increased to 34% in 2020, up 8 pp compared to 2019[15] (see Chart 1.6.1). According to the microsimulations conducted,[16] the drop in profitability was particularly steep for SMEs and, in particular, in the hospitality and entertainment, motor vehicles, wholesale and retail trade and transportation and storage sectors.

The degree of financial pressure borne by firms as a result of their indebtedness also seems to be increasing. The aggregate debt-to-GDP ratio increased by 12 pp over 2020 (see Chart 1.6.2). Slightly two-thirds of this increase would be due to the decline in output. These developments also appear to have resulted in an increase, albeit far more muted, in the interest burden ratio, thanks to low financing costs. On CBQ data, the performance of firm-level debt in 2020 indicates that the heightened financial pressure borne by this sector owes more to their lower earnings than their increased net debt.[17] Box 1.2 examines the uneven developments in bank debt across firms that presented different financial characteristics prior to the outbreak of the crisis. Box 1.3 explores measures geared towards boosting firms' solvency, in reaction to these recent developments.

The degree of final pressure on households also appears to be rising, particularly among those households most affected by the crisis. However, the public support measures seem to have helped to considerably mitigate these effects thus far. According to the Spanish Survey of Household Finances,[18] the percentage of more vulnerable households was higher in the sectors hardest hit by the pandemic.[19] In any event, social transfers in the form of unemployment

[14] Return on assets = (ordinary net profit + financial costs) / assets net of non-interest-bearing liabilities.

[15] See "The impact of the COVID-19 crisis on the financial position of non-financial corporations in 2020: CBSO-based evidence", Analytical Article, *Economic Bulletin* 4/2020, Banco de España.

[16] Microsimulations were conducted based on corporate information sourced from the integrated CBSO database for 2018 and 2019 to estimate the behaviour of firms in 2020.

[17] See Box "Recent developments in the indebtedness of the non-financial corporate sector" in the Analytical Article "Results of non-financial corporations to 2020 Q4. Preliminary year-end data", *Economic Bulletin,* 1/2021, Banco de España.

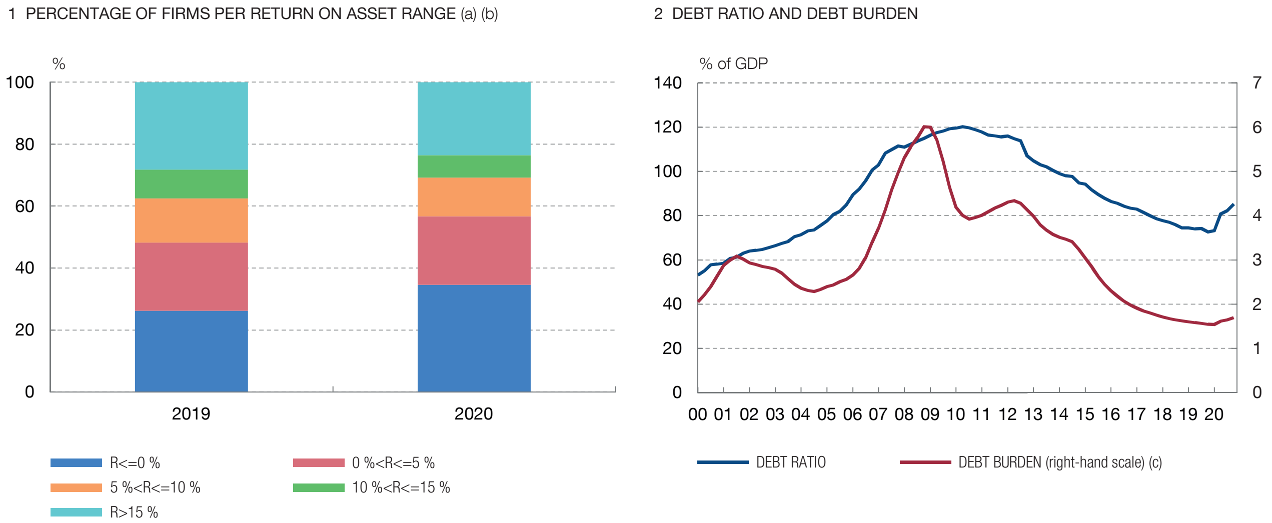
[18] The latest available Spanish Survey of Household Finances relates to 2017. However, the household-level information that the survey provides on wealth distribution among Spanish households tends to be relatively stable over time.

[19] See "The financial position of the workers most affected by the pandemic: an analysis drawing on the Spanish Survey of Household Finances", Analytical Article, *Economic Bulletin* 3/2020, Banco de España.

Chart 1.6

THE COVID-19 CRISIS HAS ADVERSELY AFFECTED THE PROFITABILITY OF FIRMS, WHICH HAVE INCREASED THEIR INDEBTEDNESS AFTER A DECADE OF DELEVERAGING

The COVID-19 crisis has entailed a sharp deterioration in corporate earnings. On the information available for the sample of firms reporting to the Central Balance Sheet Data Office Quarterly Survey, the percentage of them with a negative ordinary return on assets increased to 34% in 2020, up 8 pp on the previous year. Firms' liquidity needs have been largely covered by recourse to credit, supported by the measures deployed by authorities, which, together with a sharp contraction of GDP, has resulted in an increase in the debt ratio and, to a lesser extent, debt burden for the first time in a decade.


1 PERCENTAGE OF FIRMS PER RETURN ON ASSET RANGE (a) (b)

2 DEBT RATIO AND DEBT BURDEN

SOURCE: Banco de España.

a The data are from the Central Balance Sheet Data Office Quarterly Survey (CBQ). Return on assets = (Ordinary net profit + Financial costs) / Assets net of non-interest-bearing borrowing.
b R: ordinary return on net assets.
c The debt burden of firms only includes interest payments, given the difficulty of reliably estimating the amount of repayment instalments.

benefits, furlough schemes[20] and the minimum living income[21] have helped cushion the drop in income for these households. Likewise, the moratoria on the debt burden of households most affected by the crisis, along with those on rent payments and energy consumption, seem to have eased the pressure on these lower income households, albeit temporarily. Both the aggregate debt ratio and the debt burden in terms of gross disposable income (GDI) increased slightly in 2020. This owed to the decline in GDI (which was concentrated among certain groups) being largely offset by the decrease in the outstanding stock of credit and financial costs (see Chart 1.7.1).

Despite the crisis, the aggregate wealth of households has continued to rise thanks to saving and the increase in real estate assets, although there is a high

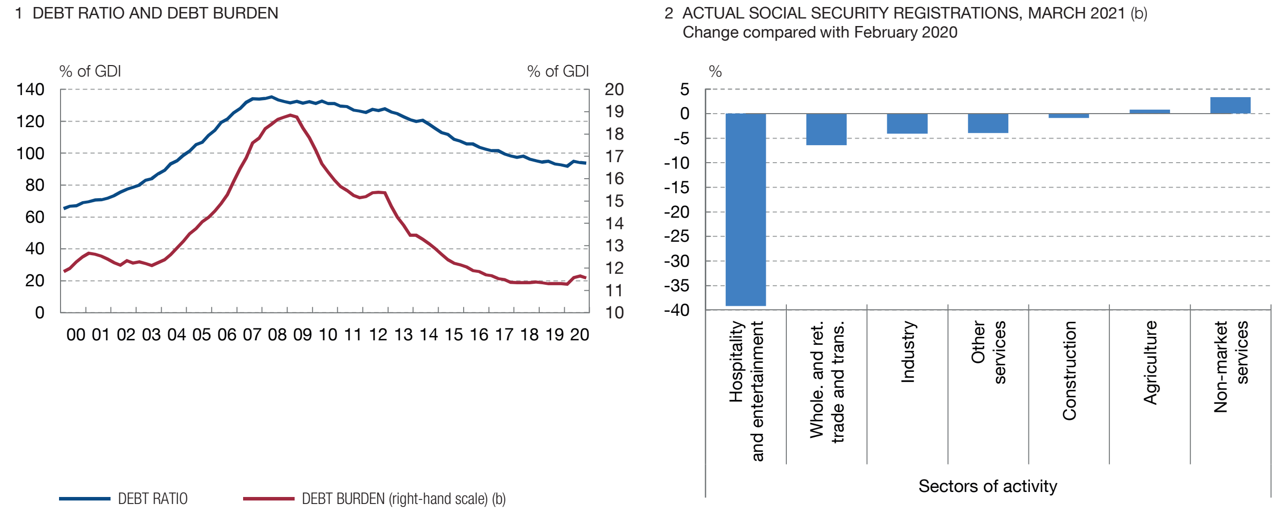
[20] At end-March 2021, the number of individuals subject to furlough schemes (ERTE by their Spanish acronym) stood at 743,628.

[21] In March 2020, the minimum living income had been granted to more than 203,000 households comprising 565,000 individuals.

Chart 1.7

ALTHOUGH HOUSEHOLDS CONTINUE REDUCING THEIR DEBT, THE FALL IN INCOME HAS DRIVEN UP THE AGGREGATE DEBT RATIO OF THIS SECTOR

Despite the pandemic, Spanish households have continued reducing their debt in aggregate terms. However, the decline in income, which has been concentrated among workers with the closest ties to those industries hardest hit by restrictions on social interaction, has driven up the debt-to-GDI ratio.



1 DEBT RATIO AND DEBT BURDEN

2 ACTUAL SOCIAL SECURITY REGISTRATIONS, MARCH 2021 (b)
Change compared with February 2020

SOURCE: Banco de España.

a The debt burden of households comprises interest payments and debt repayments.
b Social Security registrations are seasonally adjusted.

degree of heterogeneity in income and wealth levels within the sector. The household saving rate reached record highs, with most of the funds channelled towards deposits. However, in all probability, the growth in the most liquid wealth was concentrated among the least vulnerable households. The negative impact on households' employment income has varied markedly depending on the sector of employment (see Chart 1.7.2). Box 1.2 also examines the heterogeneous response to the COVID-19 crisis of bank debt among individuals with different characteristics in terms of income, employment status and other attributes that provide insight into the fragility of their income.

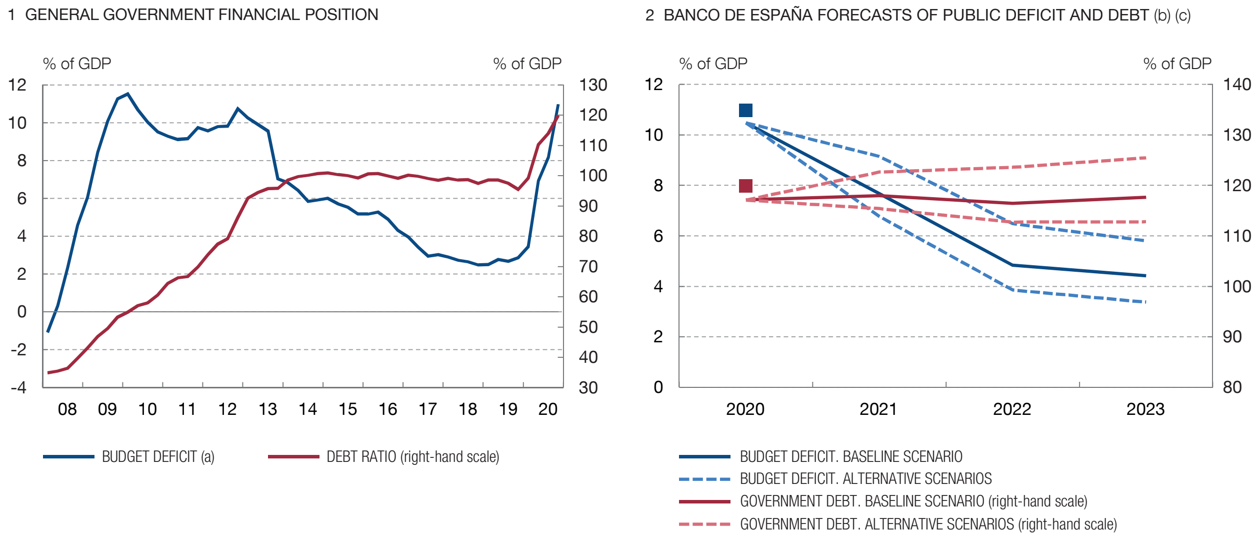
1.3.2 General government in Spain

The year 2020 ended with a pronounced deterioration of public finances in Spain owing to the effects of the pandemic and the associated containment measures. At end-2020, the general government deficit stood at 11% of GDP, notably up on the 2.9% recorded in 2019, and public debt reached 120 % of GDP (see Chart 1.8.1). The reclassification of SAREB as part of the public

Chart 1.8

THE COVID-19 PANDEMIC HAS NOTABLY IMPAIRED THE GENERAL GOVERNMENT FINANCIAL POSITION IN SPAIN

The resolute action taken by fiscal authorities in 2020 has been effective in counteracting the adverse economic effects of COVID-19. However, the resulting deterioration of public finances means greater vulnerability to potential additional shocks. In the short term, favourable financing conditions and European fund programmes should allow the expansionary fiscal policy stance to continue. The main risk for public finances continues to be a setback in resolving the health crisis that gives rise to more pronounced and persistent effects on economic activity. In the medium term, once the effects of the crisis are overcome, a credible and sustained consolidation process is required.



1 GENERAL GOVERNMENT FINANCIAL POSITION

2 BANCO DE ESPAÑA FORECASTS OF PUBLIC DEFICIT AND DEBT (b) (c)

SOURCES: IGAE and Banco de España.

a Four-quarter cumulative data.

b The budget deficit and government debt estimates for 2020 and 2021-2023 do not include the assumption of Sareb debt by the general government, a fact known after the preparation of the forecasts.

c Macroeconomic scenarios of the Banco de España projections published on March 23, 2021. The squares of 2020 correspond to the data published by the IGAE six days later.

sector[22] contributes 0.9 pp to the rise in deficit and 3 pp to the increase in public debt. The rest is explained by both a decline in revenue (-5%) and, above all, an increase in spending (10%). The former was marked by the impact of the fall-off in activity on tax bases and by the tax moratoria introduced to help firms experiencing liquidity problems; in the case of personal income tax, these were partly offset by the general government measures to support the income of private agents. In turn, spending increased as a result of the measures adopted in response to COVID-19.

The latest Banco de España projections, published in March and closed before the publication of the 2020 year end data[23], pointed to a gradual correction of

[22] The reclassification follows the criterion of Eurostat and it takes place after a negative evolution of its financial situation, marked by a continuous series of losses in later years. In accounting terms, this operation is registered as a transfer of capital from the public sector to the rest of resident agents in 2020, for the negative net accounting value of SAREB, and a rise in public debt, for an amount equal to the liabilities of SAREB.

[23] See Macroeconomic scenarios for the Spanish economy (2021-2023).

the general government balance in 2021-2023. The persistence of COVID-19 has led to the extension until 30 May 2021 of the extraordinary measures relating to furlough schemes and temporary discontinuation of activity schemes for the self-employed. The expiries of loan guarantee facilities have also been extended and new direct support measures for firms have been introduced. Later, a new package of measures has been approved to support firm solvency, including direct aid, for a total amount of €11 billion. However, a series of factors will help partially correct the deficit this year. First, a significant recovery in government receipts is expected thanks to the projected improvement in economic activity, especially in 2021 H2, and, to a lesser extent, increased tax revenue stemming from the new income measures budgeted for 2021. Second, the progressive disappearance of the bulk of the measures approved in 2020 should result in far more moderate spending growth.

Overall, in 2021 the general government balance could stand between -6.8% and -9.1% of GDP, depending on whether the macroeconomic scenario is closer to the baseline scenario or the severe scenario envisaged by the Banco de España in March (see Chart 1.8.2). The correction of the imbalance in public finances looks set to continue in 2022 and 2023 thanks to the expected cyclical improvement. Nonetheless, under any of the scenarios the deficit would remain above 3% of GDP in 2023. Government debt will hold at very high levels under any of the envisaged scenarios.

The European authorities' response to the crisis will constitute one of the main catalysts for activity in the short and medium term. The monetary measures adopted by the ECB have helped ward off tensions in the sovereign debt markets, making for highly favourable financing conditions. In the fiscal realm, the launch of the NGEU, which could finance investment projects for up to €140 billion in Spain in the next six years, will allow the country's fiscal policy to maintain an expansionary stance.

Thereafter, rebuilding Spanish public finances will require considerable effort. Authorities should devise, without further delay, a credible and sufficient fiscal consolidation programme over a long period, with implementation commencing once the health and economic crisis ends. This is needed to curb the spread of vulnerabilities from general government to other economic sectors and to foster long-term growth.

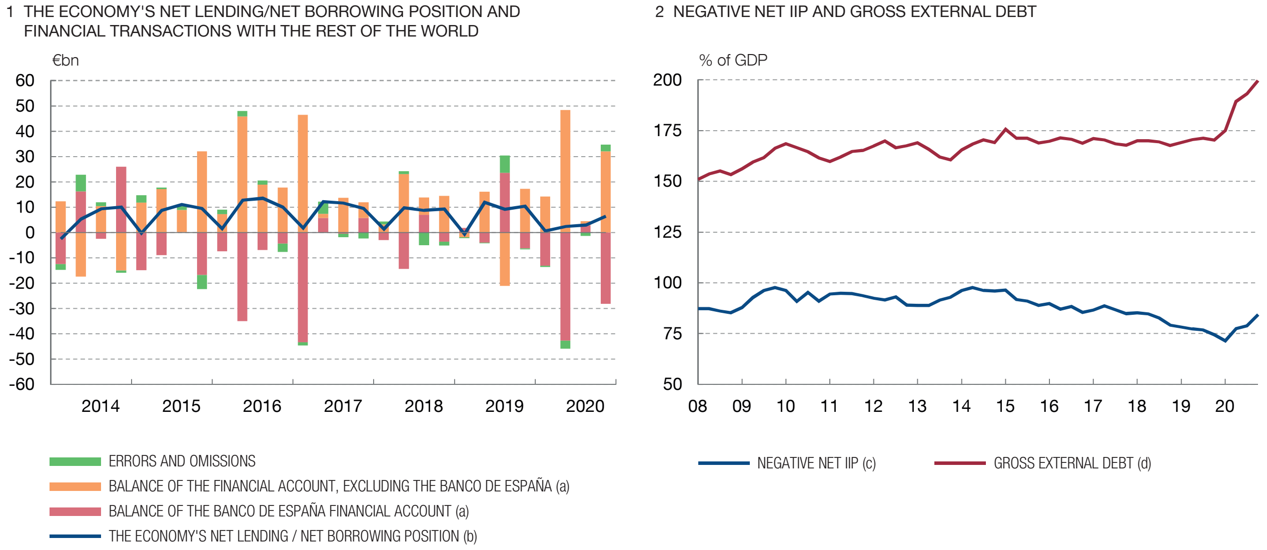
1.3.3 Financial flows vis-à-vis the rest of the world and the international investment position

In the second half of 2020, acquisitions of foreign assets by residents moderated very significantly relative to the first half of the year, while non-residents disinvested in the Spanish economy. This resulted in a reduction in the financial account surplus of the Spanish economy's balance of payments in half

Chart 1.9

IN RECENT QUARTERS, THE SPANISH ECONOMY'S NEGATIVE NET INTERNATIONAL INVESTMENT POSITION AND GROSS EXTERNAL DEBT IN TERMS OF GDP HAVE RISEN, WITH THE LATTER REACHING RECORD HIGHS

In 2020 H2, the current account surplus in the Spanish economy, excluding the Banco de España, moderated with respect to H1. This owed to purchases of foreign assets by resident sectors standing well below those of H1. The negative net international investment position (IIP) grew in GDP terms owing primarily to the decline in output. For its part, Spain's gross external debt in terms of GDP rose in 2020 to record highs due to the decline in output, but also as a result of the rise in external liabilities flows, specifically of the Banco de España and general government, and valuation effects.


1 THE ECONOMY'S NET LENDING/NET BORROWING POSITION AND FINANCIAL TRANSACTIONS WITH THE REST OF THE WORLD

2 NEGATIVE NET IIP AND GROSS EXTERNAL DEBT

SOURCE: Banco de España.

a Net change in assets less net change in liabilities.
b A positive (negative) value in the series denotes a credit (debit) position.
c The negative net IIP is the difference between the value of the external liabilities of the resident sectors and that of the assets to the rest of the world.
d External debt comprises the balance of all liabilities that entail future repayment of principal, interest or both (i.e. all financial instruments, except equity securities, financial derivatives and monetary gold bullion).

(€33.6 billion, down from €62.5 billion in the first half of 2020), excluding Banco de España (see Figure 1.9.1). On the asset side, this different behaviour in the first and second half of the year is mainly explained by the disinvestments in the heading of *another investment* worth €47.1 billion (compared to investments of €62.3 billion in the first half of the year), in particular in short-term deposits of monetary financial institutions. On the liability side, the disinvestments of long-term government debt (€23.6 billion) and of short-term deposits from monetary financial institutions (€25.7 billion) stand out. The financial account of Banco de España again presented a debtor position, although smaller in the second half of 2020 than in the first, linked to purchases of Eurosystem assets (the APP and PEPP programmes). This translated into a bulging increase in the TARGET debtor balance throughout 2020, worth €108 billion.

The Spanish economy's negative net international investment position (IIP) increased slightly in 2020 (€ 19.6 billion), while gross external debt has

increased considerably. In 2020, the negative net IIP rose by 10 pp of GDP to 84.4%, as a result not only of the increase in the numerator, but especially because of the decrease in the denominator (see Chart 1.9.2). The country's gross external debt grew in the same period by €115.2 billion, triggered by the rise in the Banco de España's external liabilities flows and, to a lesser extent, those of general government, and by the increase in the market value of these instruments. Gross external debt stood at 199.7% of GDP, an all-time high and up 29.3 pp on the figure at end-2019. The current favourable financial conditions make it easier to finance Spain's external debt, although the high level of such debt represents an element of vulnerability to a potential tightening of conditions on international financial markets. While the composition of the debt, with the public sector accounting for a large share and lengthy average repayment periods, helps mitigate these risks to some extent, its high level could magnify the impact of the financial stability risks considered in this FSR.