Foreword by the Governor Pablo Hernández de Cos

2021 was a year marked by the end of the most acute phase of the COVID-19 pandemic, the ongoing economic recovery and the sharp pick-up in inflation around the world. The Russian invasion of Ukraine in late February 2022 provided a further negative shock in a setting in which many economies, sectors, firms and households had not yet fully recovered from the adverse effects of the health crisis. As a result, the short-term growth outlook has been revised down, particularly in Europe, while inflationary pressures have increased and are expected to be more persistent than anticipated at the beginning of the year.

Against this particularly uncertain backdrop, the Banco de España's *Annual Report* presents in its first chapter an overview, against the global setting, of economic developments in the Spanish economy in 2021 and the first months of 2022, a description and evaluation of the economic policies implemented since the onset of the pandemic and an assessment of the economic outlook and main risks for Spain in the coming quarters. Chapter 2 of this report explores, over a longer time horizon, the structural challenges that the Spanish economy will have to face in the years to come, together with the main economic policy levers available to address them.

The report also includes two theme-based chapters. The third chapter provides a detailed analysis of the current inflationary episode, with a particular focus on its causes and the factors that could influence the persistence of these dynamics in the future. The fourth chapter of this report focuses on the considerable challenges that the fight against climate change and the green transition will pose for the Spanish economy in the coming years.

The performance of activity in recent quarters

The headway made in the vaccination campaign, which began in late 2020, allowed the social distancing measures that most of the world's main economies, including Spain, implemented during the height of the pandemic to be gradually eased throughout 2021, albeit with some back and forth. This helped prolong the recovery in activity that began in the summer of 2020.

However, this recovery was partially hampered by (i) the fluctuations in the health situation, (ii) the sharp rebound in energy prices, and (iii) a number of elements that limited the ability of supply to respond to the higher demand stemming not only from the improved epidemiological situation but also from the extraordinary support provided by economic policies. While the first of these factors became less and less of an impediment as 2021 progressed, the other two factors have increasingly conditioned economic performance.

In particular, although initially price rises were concentrated in commodities and food and seemed to be relatively temporary in nature, in recent quarters their intensity has systematically surprised on the upside, spreading to the rest of the goods and services in the consumption basket and showing signs of greater persistence. In the same vein, the bottlenecks that have arisen in global value and transport chains over the last few quarters for various reasons have not cleared as quickly as expected; indeed, in some cases they have even become more severe following the outbreak of war in Ukraine and the recent worsening of the pandemic in China.

Although all these constraints on economic performance are eminently global, their impact has been highly uneven across the world's major economies. Among other aspects, this heterogeneity owes to cross-country differences in terms of their productive system, access to vaccines, the capacity of economic policies to provide support and dependence on energy inputs.

In this respect, in recent quarters the economic recovery has been particularly strong in the United States, where pre-pandemic levels of activity were exceeded in 2021 H1. This high buoyancy also led to inflationary pressures emerging sooner and more forcefully in that country. By contrast, the euro area overall did not return to its pre-pandemic level of activity until late 2021.

In the case of the Spanish economy, epidemiological developments in the first months of 2021 meant relatively stringent pandemic containment measures had to be left in place, which affected economic performance. However, headway made in the vaccination campaign allowed a more buoyant phase to begin in Q2, although such dynamism was progressively tempered by the supply chain disruptions and higher energy commodity prices, which were compounded towards the end of the year by the emergence of the Omicron variant. By end-2021 the Spanish economy's GDP was still 3.8 percentage points (pp) below its pre-pandemic level.

At the beginning of 2022, the fade-out of the latest outbreak of the pandemic and some timid signs of relief in the bottlenecks seemed to be helping to mitigate the risk factors that were stymieing Spanish economic activity. Expectations of greater economic buoyancy were also underpinned by the implementation of European funds and the possible release of the savings built up by households during the pandemic.

However, the Russian invasion of Ukraine in late February has constituted a further adverse shock that is affecting Spain and other European economies, through different channels. These include the heightening of inflationary pressures on commodities, the deterioration in economic agents' confidence and the slowdown in international trade. All this has resulted in a marked worsening of growth prospects in the short term and stronger inflationary pressures. In particular, the latest Banco de España projection exercise, published in early April, revised the GDP growth rate for 2022 down (to 4.5%) and the average inflation rate for the entire year up (to 7.5%).

The information available after the publication of these projections, which includes lower-than-expected GDP growth in Q1, would point to a further downward revision of the GDP growth rate expected for this year overall, in the absence of additional shocks. On the price side, the new data points, compared with the April projections, to greater gains in the non-energy component and somewhat more modest growth in the energy component. Moreover, in the coming months the Iberian mechanism to cap the price of gas and lower that of electricity which was recently approved in Spain and Portugal, in agreement with the European Commission, will foreseeably exert downward pressure on energy prices in Spain.

In the absence of any new shocks or an escalation of the war in Ukraine, such a revision of the April 2022 projections would still be consistent with the Spanish economy holding on a gradual recovery path – one that could see it reach pre-pandemic GDP levels in the final stretch of 2023 – and with inflation rates remaining high in the coming months and subsequently moderating gradually. In any event, the uncertainty surrounding these projections is extraordinarily high.

The role of economic policy

The set of ambitious economic policy measures rolled out at the onset of the pandemic, in many cases in an internationally coordinated manner, has played a key role to mitigate the impact of the health crisis on the income and financial position of households, firms and financial institutions, and ultimately on economies' activity, employment and potential growth.

Before the outbreak of the war in Ukraine, the ongoing economic recovery and the sharp pick-up in inflation had already prompted a certain normalisation of some of these expansionary measures, particularly in the monetary and fiscal policy arena. The war has undoubtedly complicated matters for policymakers.

(i) Fiscal policy

As regards fiscal policy, it is imperative that, against the backdrop of a still incomplete recovery, budgetary policy help to counter the Ukraine war's adverse effects on activity. Once again, these effects are highly uneven across sectors, firms and households.

However, against a background of relatively limited leeway – considering our high levels of government debt –, it is essential that these support measures be designed to closely target the most vulnerable households and firms. In particular, in the current situation the efforts should focus on supporting lower-income households, which are those hit hardest by inflation, and the firms most vulnerable to this new shock.

In addition to being targeted, it is important that the budgetary measures implemented be temporary and not significantly skew price signals. Averting any feedback into the current inflationary process is a further reason to avoid an across-the-board fiscal impulse and the widespread use of automatic indexation clauses in expenditure items. This deindexation must be part of the incomes agreement that I shall turn to now.

(ii) An incomes agreement

Beyond the fiscal policy response, an incomes agreement between social partners in our country would help avoid a spiral of price and cost increases, which would only exacerbate the harmful effects stemming from the current inflationary episode and the war in Ukraine. In particular, under such an arrangement, firms and employees would agree to share the inevitable loss of income in the national economy that higher commodity import prices entail.

The asymmetric impact of the current shocks on employees, firms and sectors should be considered when determining the specific characteristics of this incomes agreement. Given this asymmetry, the necessary coordination at national level must be combined with mechanisms to adapt the agreement to the existing differences in productivity and activity across firms and sectors. Equally, where the standard of living of certain segments of households has been hit particularly hard by rising energy costs, the incomes agreement should seek to mitigate their straitened circumstances. In short, these considerations suggest that a potential incomes agreement should avoid overly sweeping measures that might prove too rigid for certain groups of agents.

It would also be desirable to avoid arrangements that automatically link wages to past inflation or indexation clauses. The aim is precisely to reduce the risk of triggering a wage-price feedback loop. In addition, the incomes agreement should include multi-year commitments relating to both wage increases – where the nominal benchmarks for wage bargaining should exclude components associated with energy products and should be based on the projected trend in underlying inflation – and to job protection. Likewise, these wage guidelines should be accompanied by explicit profit margin moderation commitments.

(iii) Monetary policy

In response to the current strong inflationary pressures, the central banks of the main developed economies have moved towards monetary policy normalisation.

Indeed, inflation in the euro area reached 7.5% in April, the highest figure in the history of the monetary union. Although the bulk of this increase has owed to the upturn in the price of energy and, to a lesser extent, food, underlying inflation has also risen noticeably.

According to the consensus macroeconomic projections, inflation will remain high over the coming months. However, in the absence of fresh inflationary stocks, it would then gradually ease towards levels consistent with the European Central Bank's (ECB) target of 2%. Indicators of medium and long-term inflation expectations also stand at around 2%.

However, the upside risks surrounding this outlook have increased. The escalating inflationary pressures in recent months drive up the likelihood of the indirect and second-round effects becoming more acute. Although these effects have not materialised significantly for the time being, there are signs, which will need to be monitored closely, that medium-term inflation expectations could be revised to above-target levels. By contrast, the war is having an adverse effect on economic growth of uncertain severity, which could reduce inflationary pressures in the medium term.

Against this background, the ECB has begun the process of monetary policy normalisation, starting from an extraordinarily accommodative position and under the framework of the new strategy approved by the Governing Council in 2021, which establishes a symmetric 2% inflation target over the medium term. The symmetry refers to the commitment to combat deviations both above and below the target. The medium-term orientation means that decisions will depend on inflation expectations over a two or three-year horizon.

This framework was expressed in the forward guidance, stating that the first interest rate increase would be conditional on expected inflation standing at 2% over an 18-month horizon and holding at 2% in the medium term, and developments in underlying inflation being consistent with inflation stabilising at 2% in the medium term. Net purchases under the Asset Purchase Programme (APP) are also linked to these conditions, with the guidance stating that interest rates will only rise some time after the net purchases come to an end.

Given this strategy and in the current context, a gradual withdrawal of the extraordinary monetary stimulus is appropriate: inflation expectations over intermediate horizons and in the medium term stand at around 2%, underlying inflation is clearly above 2% and there are risks of upside deviations from the projections. One benchmark that could inform this normalisation process is the level of the natural interest rate, which is defined as the rate that maintains inflation stable at its target level. According to the estimates available, which are subject to much uncertainty, this interest rate is at low levels in the euro area, hovering around or slightly above 1%. This would suggest that, until such levels are reached, the monetary policy stance will continue to be expansionary.

Net purchases under the pandemic emergency purchase programme (PEPP) were discontinued in March 2022. In addition, at the Governing Council meeting in April we announced that net purchases under the APP would end in the third quarter of the year. In my view, given that the inflation outlook fulfils the conditions in our forward guidance, purchases under the APP should conclude in early Q3 so that the first interest rate increase can take place shortly after. Successive additional increases could follow over the subsequent quarters until, for example, levels consistent with the natural interest rate are reached, if the medium-term inflation outlook holds close to our target.

Against a particularly uncertain backdrop, we are emphasising that interest rate increases must be gradual. The aim is to avoid abrupt movements, which could be particularly harmful in the current context of heightened uncertainty. If this gradual approach is to be adopted, it is essential that inflation expectations remain anchored and that no indirect or second-round effects arise on a scale that could jeopardise such anchoring.

In addition, given that uncertainty, we have no pre-established guidelines for the normalisation. We will have to fine-tune the normalisation process based on the incoming data. It should be borne in mind that the current uncertainty relates to aspects of such importance for future inflation as the course of the war, the clearing of the bottlenecks in production and international transport, the extent to which second-round effects materialise, globalisation dynamics and policies on energy and climate change mitigation.

We will act with total flexibility and adopt the measures needed to fulfil our mandate and contribute to safeguarding financial stability. Along the path to a more neutral interest rate configuration, flexibility is particularly important to preventing the emergence of threats to the correct transmission of monetary policy throughout the euro area. The pandemic has shown that, under stressed conditions, flexibility in asset purchases helps to counter these threats more effectively. Within our mandate, this flexibility will remain a key element of our monetary policy.

(iv) European policies

European policies are playing an increasingly important role in contending with common shocks to the European Union (EU) economies as a whole. This was thrown into relief when the pandemic broke out and Next Generation EU (NGEU) – among other pan-European measures – was launched, making a very substantial volume of funds available to the Member States. More recently, the importance of European policies has also become clear as a result of Russia's invasion of Ukraine, to which, for example, the EU has responded collectively by imposing severe economic sanctions on Russia.

The growing significance of European policies – as a crucial factor in economic developments in the Member States – renders all the more important continuing to push on with the development of the European institutional framework. In this regard, prominent among the main initiatives that, in recent months, have aroused growing interest in the European institutional discussion are the EU's proposals to increase its autonomy of decision and action in the extremely important energy, technology and digital arenas. It is essential that, in these fields, the policies be designed and implemented so as to minimise the risk of fragmentation within the EU and of undesired distortions emerging. Thus, based on the experience gained with NGEU, a common fiscal response to the challenges posed by the war in Ukraine would be desirable, including pooling the government spending needed to address its effects on the Member States' economies.

In addition, the European Commission is currently reviewing the European fiscal rule framework. It bears repeating that a fiscal rule framework that ensures the sustainability of public finances is absolutely necessary for the smooth functioning of the euro area. The fiscal discipline induced by a credible framework of rules is essential. The reform should align the framework with the structural economic transformations that have arisen since its creation, including the developments in long-term interest rates and the potential growth of the economies, which are fundamental determinants of debt sustainability. These developments, which have been uneven across countries, together with the high disparity of the Member States' current budgetary imbalances, would require rules that take a more individualised approach. The current framework also needs to be simplified, by, for example, establishing a rule for government expenditure growth that is anchored to the general government debt-to-GDP ratio. Its hitherto scant capacity to ensure that countries build up fiscal buffers in good times for use in crises must also be improved. This requires improving the design of the system of incentives governing compliance with fiscal rules and possibly strengthening the role of independent fiscal institutions such as AIReF.

Making headway in the expansion of the public and private risk-sharing channels in the EU is also essential. In this regard, we need a permanent macroeconomic stabilisation mechanism in the euro area that complements monetary policy. To do so, it needs sufficient resources and revenue-raising and borrowing capacity. Progress is also needed on the capital markets union agenda and in completing the banking union, specifically ending the current deadlock over its third pillar, a European Deposit Insurance Scheme with a risk-pooling component.

The Spanish economy: structural challenges and policies to address them

The Banco de España has detailed, in various reports, the main challenges that will influence the course of the Spanish economy over the years ahead.

Most of the challenges facing the Spanish economy clearly pre-date the pandemic. Examples here include the need to boost productivity growth, to correct dysfunctions in several goods and factor markets, to make public finances more sustainable and to address the challenges posed by population ageing, inequality and climate change. However, others are relatively new, such as the need to adapt to an accelerated digitalisation of economic activity and to the recent changes in globalisation dynamics.

In any event, the scale of the challenges and their close interrelatedness call for a comprehensive strategy of lasting and ambitious structural reforms. The Spanish economy's ability to follow a robust, sustained and inclusive growth path will hinge on the economic policy response to this set of challenges.

(i) The challenge of boosting job creation and strengthening employment stability

Among the challenges highlighted in Chapter 2 of this *Annual Report* is that of reducing the unemployment rate and temporary employment ratio, which have been persistently high in Spain in recent decades. Young people have been particularly affected, with their rate of involuntary part-time employment having grown since the global financial crisis.

Reducing this high employment instability is key, as it has adverse economic effects in many spheres. For example, employment instability affects the accumulation of workers' human capital and can thus have very persistent effects on their working lives. Furthermore, it also increases uncertainty over the future path of the incomes of the affected workers. This not only has consequences for spending decisions, but also for emotional well-being, the formation of new households and the birth rate.

In this setting, one of the main objectives of the labour market reform enacted in 2022 is to combat the high proportion of temporary employment. Since its approval, permanent hiring has quickened significantly and temporary hires have slowed. It is, however, still too early to assess the impact of the labour market reform, and any such evaluation will have to consider multiple issues.

Notable among them is the impact on employment because, in principle, the reduction in temporary contracts might stem from both temporary employment being replaced by permanent employment and from the destruction of temporary jobs. Answering this question will require an extensive period in which to analyse job creation and destruction dynamics.

(ii) The challenge of training and increasing human capital

Increasing the educational attainment level of workers and employers is also crucial to reducing structural unemployment, boosting productivity and fostering the creation of higher quality jobs. Tackling this challenge is especially important at the current juncture, given the confluence of an intense digitalisation of economic activity, marked population ageing and various factors that may require a profound cross-sectoral reallocation of activity.

In this regard, given the current changes in the demand for training, which are likely to intensify in the years ahead, the education system should be flexible and provide a decisive response. In addition, harnessing the opportunities of digitalisation calls for increasing the population's digital skills, especially in the case of the older generation, those with lower educational attainment levels and those on lower incomes.

Furthermore, a comprehensive retraining strategy throughout the life cycle is key in a setting in which society finds itself faced with marked population ageing and, at the same time, the need to extend people's working life.

Active labour market policies are also vital to limiting the loss of human capital stemming from job losses. It is thus important to design an active labour market policy system that is efficient and effective.

(iii) The challenge of addressing inequality

Levels of inequality in Spain were already high before the outbreak of the pandemic and, despite the key mitigating role played by public policy, they are likely to have increased as a result of the health crisis. To reduce the adverse – economic and social – effects of high levels of inequality, public policy measures must be rolled out and continuously assessed across a wide range of areas. Examples here include labour market regulation and education policy, and also income and housing policies.

In particular, improving the educational attainment levels of the most disadvantaged groups is a highly effective means of boosting their income, levelling up job opportunities ex ante and enhancing the prospects of future generations.

As far as incomes policies are concerned, according to the findings of the assessments required by law, further adjustments must be made to the conditions governing eligibility for Spain's minimum income scheme, to ensure that this instrument can effectively fulfil its mission of eradicating extreme poverty while avoiding undesired effects.

Steps should also be taken to reduce the adverse effects of inequality in the area of housing affordability, which has tightened in recent years. In this respect, the draft Law on the right to housing seeks to ease such difficulties in accessing housing, which hit the young and lower-income households particularly hard. However, some of the measures envisaged, such as rent control, may not have the desired effect or may even have adverse effects in the medium term. Conversely, certain measures that could give a significant structural boost to the supply of rented housing, such as offering greater effective legal certainty to landlords, are absent.

(iv) The challenge of increasing firm size, facilitating cross-sector reallocation and fostering innovation

Another major challenge for the Spanish economy is the small size of businesses, which has a bearing on the country's low aggregate productivity. To tackle this challenge, it is essential to explore the various reasons why our business sector is so skewed towards small, low-productivity firms and to mitigate the effects.

For example, as part of a strategy to stimulate business growth, smaller firms should be helped to access a wider range of external sources of funding on more advantageous conditions, while the policies in support of business innovation should be strengthened.

Another aspect where action would be desirable is the regulation of economic activity, an area that has increased in complexity in recent decades, with a potentially adverse impact on business dynamics and aggregate productivity.

Some recent initiatives in this area appear to be a step in the right direction, such as the draft Law on business start-ups and growth (which seeks to boost business start-ups and foster their expansion by improving regulations), removing barriers to economic activity, combating business defaults and providing financial support for business growth. Another is the reform of the Insolvency Law, which brings in significant changes to insolvency and pre-insolvency procedures and may help partially remedy the shortcomings of the current insolvency mechanisms. However, looking ahead, how well these new pieces of legislation are able to significantly mitigate the shortcomings observed in Spanish business dynamics in recent decades will need to be carefully assessed.

(v) The challenge of fully capitalising on the roll-out of the Next Generation EU (NGEU) programme

As highlighted in the Banco de España *Annual Report* 2020, one of the main challenges we face in the coming years is how to fully harness the possibilities offered by the NGEU programme to drive a profound structural transformation of our economy.

The short-term economic impact of the take-up of these funds in 2021 was smaller than that included in our macroeconomic projections. Nonetheless, a significant part of the expected economic growth for 2022 and for the next few years crucially hinges on the potential multiplier effect on activity of the use of the NGEU funds. In this respect, the rigorous selection of the investment projects to be funded under the NGEU programme is one of the factors that may have the greatest impact on maximising this impact and, therefore, the success of this mechanism in Spain.

There is also a very high degree of complementarity between the financing of investment projects, such as those envisaged under the NGEU programme, and the implementation of structural reforms. This is highlighted by a recent paper by the Banco de España, which illustrates how the impact of different combinations of reforms and investment projects on the Spanish economy's medium-term growth capacity could vary considerably. In particular, according to the findings of the paper, if a careful selection of NGEU projects is also accompanied by various structural reforms to ease the existing rigidities in the product and labour markets, thereby helping to reduce the structural unemployment rate and boost productivity, the potential growth rate of the Spanish economy could reach around 2% by the end of that decade, nearly 1 pp higher than under a scenario of no NGEU projects or structural reforms.

(vi) The fiscal consolidation challenge

Maintaining high levels of government debt over time is a considerable source of vulnerability for Spain and leaves less fiscal space in the event of possible future macro-financial shocks.

In this setting, the sustainability of Spanish public finances needs to be bolstered in the medium term. To this end, a multi-annual fiscal consolidation plan will have to be rigorously implemented, once the pandemic is over and the adverse economic effects of the war in Ukraine have diminished. Although the necessary fiscal adjustment should be carried out gradually, once the ongoing recovery trajectory of the Spanish economy is firmly established, the definition and early communication of this comprehensive plan – in which all tiers of general government should participate – would be desirable, as this would help boost confidence and certainty about Spanish economic policies. Such confidence is particularly important in the context of monetary policy normalisation and consequent tightening of financial conditions in which we find ourselves.

As part of this plan, general government expenditure policies must be subject to an exhaustive review, with two essential aims: to increase the efficiency of each budget item and to optimise the distribution of public expenditure between items in order to promote more robust and equitable economic growth.

Similarly, a comprehensive review of the Spanish tax system is needed to ensure that the different taxes meet their goals in the most efficient and most effective manner possible.

As regards the pension system, on the estimates available, which include the latest measures adopted in this area, fresh future actions will be needed on either the revenue or the expenditure side, or on both sides, to cater for the growth in pension expenditure stemming from population ageing.

In this respect, in recent years the Banco de España has been pointing to the need to strengthen the link between contributions made and benefits received – while ensuring a sufficient level for the most vulnerable households – and to launch a rigorous debate to address the level of benefits the system should provide and the question of how the revenue required to fund those benefits can be raised.

Moreover, the consequences of the reforms envisaged in terms of redistribution and intergenerational equity must be analysed, to ensure that any adjustments to the system do not fall disproportionately on specific population groups, such as the retired population or future cohorts of workers. The system should also be made more transparent and easier to plan for, to offer greater certainty to the population and facilitate decision-making as regards saving, work and retirement. In this respect, automatic adjustment mechanisms could possibly be introduced, to adapt certain pension system parameters to changes in demographic and economic dynamics.

(vii) The challenge of the fight against climate change and the green transition

The fight against climate change and the transition towards a more sustainable economy are, without doubt, the most significant challenges facing Spain.

As Chapter 4 of this *Annual Report* highlights, resolutely addressing this challenge will entail a profound structural change in our economic growth model that will have very important implications for almost all areas of activity. This transformational process will also foreseeably have a very unequal impact on Spain's different regions, industries, firms and households, and it may affect some more vulnerable households and firms more severely.

In this green transition, governments have a leading role to play. Essentially, through green taxation, the roll-out of compensatory measures to temporarily mitigate the transition costs for the most vulnerable groups, public investment and regulation of economic activity.

Once again, a comprehensive European response to address the global challenge of climate change would be more effective and more efficient. In particular, not only through tax coordination, but also through the creation of a common European financial instrument that facilitates the large-scale common investments needed to meet the net zero emission targets and dispel the climate-related risks, regardless of the fiscal space available in each country.

Naturally, both the financial system and central banks – each within their respective competences – also have a contribution to make to the green transition. In this respect, from the standpoint of the Eurosystem in general, and of the Banco de España in particular, one priority at present and in the more immediate future is to make headway, in conjunction with the financial system, in incorporating climate considerations into the operating frameworks of monetary policy, financial stability, supervision and regulation.

Banking sector challenges

Complementary to this *Annual Report,* our *Financial Stability Report* published in May analyses the situation of the Spanish banking sector in depth.

The sector is facing the shock caused by the Russian invasion of Ukraine, in a setting in which its resilience remains generally high, returns have recovered their pre-pandemic levels and lending has normalised.

Yet the war in Ukraine entails new risks to financial stability. Although Spanish banks have very little direct financial exposure to Russia and Ukraine, the indirect effects of the war may be significant. Particularly through its impact on households and firms, especially for those experiencing a slower or tardy recovery from the pandemic and whose solvency may now have worsened.

Thus, in the business sector, although the recovery in sales and the more moderate debt growth in 2021 have prompted an improvement in businesses' overall financial situation, on average this continues to be more vulnerable than before the pandemic. In the sectors hardest hit by the pandemic, the percentage of highly indebted firms[1] is 7 pp higher than in 2019.

In the case of households, the favourable course of the labour market and household income is also helping them to recover their economic-financial situation. In any event, in the top net wealth decile, although the debt-to-asset ratio has fallen, debts continue to be some 50% higher than asset values, indicating the extent of this group's financial vulnerability.

Against this backdrop, lending in Spain fell slightly in 2021. Firms' demand for credit was lower, as they faced lower liquidity needs than in 2020, but this was largely offset by stronger lending to households, especially in the loans for house purchase segment.

In turn, non-performing lending to the resident private sector fell by 5.4% in 2021, to €49.3 billion, a larger drop than in 2020 but well below those recorded in the pre-pandemic years. Despite this favourable NPL performance, there is still some latent credit portfolio deterioration. Loans with significant increase in credit risk since initial recognition (Stage 2 loans) continued to grow at high rates in late 2021 (by 14% year-on-year). Forborne loans also rose by 14% (compared with a fall of 9% in 2020), owing to the sharp growth in the non-financial corporate sector and among sole proprietors.

Vulnerability is highest among the sectors sensitive to the effects of the pandemic and to the rising energy costs; at December 2021, almost 24% of their loans were either non-performing or Stage 2 exposures. Indeed, credit exposures with some sign of impairment may be most vulnerable to the materialisation of risk in the present setting. Accordingly, careful monitoring is needed, together with early and correct recognition of potential losses.

1 Firms are defined as being highly indebted if their ratio of net debt / (gross operating profit + financial revenue) is higher than 10 or if they have positive net financial debt and zero or negative earnings.

The Spanish banking sector's consolidated income improved substantially in 2021, following the poor 2020 figures. The main determinant of the improvement in ordinary income was the decline in impairment losses on financial assets. Moreover, the CET1 capital ratio held relatively steady in 2021, after increasing in 2020, so the health crisis has not lessened the banking sector's overall capacity to absorb unexpected losses.

The stress tests conducted by the Banco de España show that the banking sector maintains its correct aggregate resilience to the macro-financial risks identified in the present setting, albeit very unevenly across banks. Even so, there would be some capital charge under the most extreme scenarios. Accordingly, close monitoring of financial developments in the sector is required, together with prudent and forward-looking behaviour by the banks themselves.

These short and medium-term challenges must not allow us to overlook the need to address the structural challenges that the banking sector was already facing before the onset of the pandemic and the Russian invasion of Ukraine. In particular, the need for capacity adjustment, as well as the growing competition from technology firms and the potential negative effects associated with climate risks.

Lastly, crypto-assets, which are digital representations of value and rights based on distributed ledger technology, are an area of financial innovation that is growing fast. Despite their potential for offering lower transaction costs, greater interoperability and greater competition, and although they are still small and their degree of interconnectedness with the more traditional financial markets is still limited, their rapid development poses significant risks if it is not conducted safely within a regulatory framework that will mitigate the potential risks. These include market, liquidity, operational, reputational and, above all, conduct risks vis-à-vis users owing to the lack of transparency and regulation in this field. In short, an upscale in these markets could pose systemic risks.

Conclusions

A reminder, to conclude this foreword to the *Annual Report,* that the Spanish economy is immersed in a highly uncertain environment, the structural challenges ahead are enormous, and that the fact that these challenges are closely interconnected signifies that a comprehensive strategy of ambitious and lasting reforms is required. Only a resolute economic policy response to the multiple short, medium and long-term challenges facing the Spanish economy will enable us to follow a robust and sustained growth path that offers opportunities for all in the coming years. This response must also be long-lasting and thus requires a broad political and social consensus. The new uncertainties generated by the war in Ukraine and the persistent uncertainties stemming from the pandemic – two absolutely extraordinary events – demand no less.

Pablo Hernández de Cos

Governor of the Banco de España

Foreword to the *Annual Report 2021.*

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