

Annual Report: Digest

The firming of the economic recovery and the rise in inflation at the global and euro area levels

- The recovery in activity that began in the summer of 2020, after the most acute phase of the pandemic had passed, continued in 2021 and early 2022.
- However, the recovery was incomplete and is shrouded in uncertainty. In particular, economic activity has been held back by the successive waves of the pandemic, the emergence of disruptions in global supply chains, the sharp rise in inflation and, in 2022, the war in Ukraine.
- The economic revival has, moreover, been uneven across geographical areas and sectors. The notable cross-country differences in the extent to which pre-crisis GDP levels have been regained are largely explained by the productive system (in terms of the importance of the sectors most exposed to social interaction and to global supply chains), differential access to vaccines and the different capacity of economic policies to provide support.
- The United States exceeded pre-pandemic levels of activity in 2021 H1. However, in the euro area overall this did not happen until the end of the year. In the emerging market economies the economic recovery has generally been held back by the relative delay in the vaccination process.
- International goods trade, which had already surpassed pre-pandemic levels by end-2020, has performed somewhat differently across regions. It grew relatively modestly in the major advanced economies, where the industries most affected by global production chain disruptions account for a larger share of the productive system. In Europe, trade was also marked by the United Kingdom's exit from the single market.
- Since the beginning of 2021, the increase in commodity prices and the disruptions in supply chains have led to a surprisingly steep and persistent uptick in inflation across all geographical areas. The war in Ukraine has exacerbated these inflationary pressures, whose causes are analysed in Chapter 3 of this report.
- Expectations of a faster-than-anticipated withdrawal of monetary stimuli in response to the uptick in inflation and higher risk aversion following the outbreak of the war in Ukraine have tightened global financing conditions since the beginning of 2022, particularly in the emerging markets.

Positive and negative aspects of the recovery in Spain

- The Spanish economy's GDP grew by 5.1% in 2021 overall. Output continued to grow in 2022 Q1, albeit at a quarter-on-quarter rate of 0.3%, considerably slower than in 2021 Q4 (2.2%).
- That said, in 2022 Q1 economic activity in Spain stood 3.4 pp below the pre-pandemic level, while, in the euro area as a whole, GDP stood 0.4 pp above its pre-crisis level.
- From the standpoint of the components of demand, Spain's straggling recovery is attributable to services exports, private consumption and residential investment.
- From the sectoral standpoint, the gap between Spain and the rest of the euro area is mainly indicative of the Spanish economy's specialisation in the sectors hardest hit by the pandemic (particularly those relating to tourism). In addition, these sectors have performed less favourably in Spain than in the euro area as a whole.
- In any event, over the course of 2021 there was an intense shift in the strength of activity across sectors in Spain. In particular, activity in the hospitality and leisure sectors became more dynamic as vaccination enabled the pandemic containment measures to be lifted.
- In turn, supply difficulties affecting certain inputs and their rising cost moderated the recovery in industry and construction in 2021 H2.
- By demand component, household consumption recovered significantly, but not enough to return to pre-pandemic levels, against a backdrop of a declining, albeit still relatively high, saving rate.
- The relatively high growth of private productive investment was dampened by several factors, including the persistence of pandemic-related uncertainties, bottlenecks and rising energy costs.
- External demand contributed positively to GDP growth. Tourism exports recovered gradually but robustly as international travel restrictions were eased. By contrast, the momentum of goods trade flows was constrained by the bottlenecks.
- Public finances continued to show a considerable imbalance in 2021, although the deficit was reduced significantly. In particular, public expenditure growth moderated due to the reduction in pandemic-related outlays. Government receipts were more buoyant than suggested by developments in the macroeconomic variables proxying their tax bases.

Positive and negative aspects of the recovery in Spain (cont'd)

- The recovery in employment was particularly vigorous throughout 2021, albeit with notable differences across sectors. At the beginning of 2022 it has shown some incipient signs of waning.
- As in other geographical areas, consumer prices have accelerated sharply since the start of 2021. Most of the increase in inflation is attributable to higher energy prices but, more recently, the pace of inflation in the other components has also increased.
- In any event, the pass-through of the higher cost of inputs to non-energy prices has been incomplete to date.
- The war in Ukraine has further driven up energy prices and has exacerbated some of the distortions in global value chains. This could lead to inflation becoming more persistent, with the ensuing risk of the emergence of the price-wage feedback loop known as second-round effects.
- Financing conditions, which remained comfortable throughout 2021, began tightening in the early months of this year.



The Spanish economy amid uncertainties

- The direct effects of the war in Ukraine on Spanish foreign trade should be moderate, given the likewise small size of the bilateral trade flows with Russia and Ukraine.
- However, the indirect effects will foreseeably be significant.
- Specifically, the war will adversely affect activity in Spain through an additional increase in commodity prices (with the added risk of the supply of one or more of these inputs being interrupted), its impact on the confidence of households and firms, the impairment of world trade and a tightening of financing conditions.
- Accordingly, the war can be expected to delay the gradual recovery that was under way in the Spanish economy.
- The Banco de España's latest projections, of April 2022, envisage GDP growth of 4.5% in 2022 and inflation of 7.5% in annual average terms.
- The information that became available after the publication of these projections, which includes lower-than-expected GDP growth in Q1, would, in the absence of any additional considerations, point to a downward revision of the GDP growth rate expected for this year overall. Moreover, on the price side, the new data point to sharper increases in the non-energy component than envisaged in the April projections.
- In any event, the outlook for the Spanish economy – and for our European peers – in the coming quarters is subject to extraordinary uncertainty, affected by a very broad range of macro-financial, geopolitical and health aspects of varying severity.

Economic policies

- Economic policies continued to provide very considerable support to activity in 2021, both globally and in Spain. Yet the persistence and intensification of the upsurge in inflation meant that, over the course of last year, some of these economic policies began shifting towards normalisation.
- Against this background, in recent months the European Central Bank has been moving in the direction of monetary policy normalisation, emphasising that, in an extraordinarily uncertain setting and provided that euro area medium-term inflation expectations remain anchored around its 2% target, its monetary policy response will depend on the performance of economic indicators, in addition to being gradual and maintaining all the optionality and flexibility provided by its various instruments.
- At the domestic level, the furlough schemes and the ICO guarantee facilities have been effective in promoting the return to work and mitigating the impact that restrictions on activity had on firms' liquidity. The direct assistance scheme for SMEs seems to have contributed to reducing a small part of the solvency problems faced by these firms as a result of the health crisis.
- Following the outbreak of the war, fiscal policy must once again seek to minimise the adverse economic and social effects of a damaging, exogenous shock. In any event, it is imperative that the measures deployed in this connection to support households and firms be targeted at the most vulnerable groups and be temporary.
- 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 of 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 SPANISH ECONOMY: BETWEEN OVERCOMING THE PANDEMIC AND THE UNCERTAINTY CAUSED BY THE WAR IN UKRAINE

	 KEY DEVELOPMENTS	 ECONOMIC POLICIES
2021 H1	<p>Economic activity in Spain was influenced by epidemiological developments and the measures to contain the disease, which hindered its recovery, particularly in the services sector.</p> <p>Progress in the vaccination campaign raised hopes that the health crisis would be overcome and, therefore, that a more vigorous recovery in activity would be seen in the second half of the year, underpinned by favourable employment developments.</p>	<p>Monetary and fiscal policies provided crucial support to activity in the face of fresh waves of the pandemic, although the vaccine roll-out raised the prospect of their progressive normalisation.</p>
2021 H2	<p>The lifting of the containment measures was conducive to the sectoral shift of activity towards services. However, the supply chain disruptions and rising commodity prices, particularly of energy commodities, hampered the recovery in manufacturing.</p> <p>Uncertainty over the duration of the inflationary pressures and the bottlenecks, together with the new variant of the virus, threatened the recovery path in the final stages of the year. By contrast, expectations of a possible release of the built-up savings and of the rollout of NGEU funds suggested activity would be buttressed somewhat.</p>	<p>The process of monetary policy normalisation began, due to the increase in inflation, although the broadly expansionary stance remained.</p>
2022 Q1	<p>The recovery regained momentum in the initial weeks of the year thanks to the improving epidemiological situation and some timid signs of the bottlenecks clearing. However, the invasion of Ukraine has entailed, through various channels, a new shock to economic activity and prices: a fresh rise in commodity prices, private agents losing confidence and a slowdown in international trade.</p> <p>The war has generated considerable uncertainty, with risks to the downside for activity and to the upside for inflation.</p>	<p>Monetary policy must be guided by the price stability mandate and not overreact to developments in the more volatile components.</p> <p>Fiscal policy must mitigate the adverse effects of the new shock, but selectively given its scant room for manoeuvre (particularly in Spain). An incomes agreement would be highly desirable.</p>

SOURCE: Banco de España.

A broad range of structural challenges and policies to address them

- In this extraordinarily uncertain time, the performance of activity in Spain over the coming quarters will be chiefly determined by overcoming the COVID-19 health crisis, how the war in Ukraine unfolds and the degree of persistence of the current inflationary episode.
- However, over a longer time horizon, the outlook for the Spanish economy will be shaped by a set of tremendous structural challenges.
- This chapter presents the main structural challenges facing the Spanish economy over the years ahead and some of the economic policy levers available for tackling them.
- The Spanish economy's ability to follow a robust, sustainable and inclusive growth path in the medium and long term will hinge on the economic policy response to this set of challenges.
- In this respect, the scale of these challenges and their close interrelatedness call for a comprehensive strategy of lasting and ambitious structural reforms.

The challenge of boosting job creation and strengthening employment stability

- In recent decades, Spain's unemployment rate and temporary employment ratio have, on a persistent basis, been significantly higher than the average of the euro area economies.
- Young people have been particularly affected, with their rate of part-time employment having grown since the global financial crisis.
- High instability affects the accumulation of workers' human capital and can thus have very persistent effects on their working lives.
- Employment instability also affects uncertainty over future income. Greater uncertainty has direct consequences for spending decisions, but also for emotional well-being, the formation of new households and the birth rate.
- In a setting like the present one, in which new forms of employment are emerging, it is even more important to address the challenges posed by employment instability, such as the challenge posed by digital commerce platforms. Although these new forms of employment have developed relatively quickly, very little is as yet known about their relative importance or their implications.
- One of the main objectives of the labour market reform enacted in 2022 is to combat the high proportion of temporary employment.
- In recent months, permanent hiring has quickened significantly, and temporary hires have decreased. It is, however, early to assess the impact of the labour market reform, and any such evaluation will have to consider numerous 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 over which to analyse job creation and destruction dynamics.

The challenge of training and increasing human capital

- Increasing the educational attainment level of workers and employers is crucial to reducing the level of structural unemployment, boosting productivity and fostering the creation of higher quality jobs.
- The education system should be adapted to provide a decisive response to the current changes in the demand for training, which are likely to intensify in the years ahead.
- Harnessing the opportunities of digitalisation calls for increasing the population's digital skills, especially in the case of the older generation, those with lower education attainment levels and those on lower incomes.
- A comprehensive skill recycling 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 for limiting the loss of human capital stemming from job losses. It is important to design an active labour market policy system that is efficient and effective.

COMPREHENSIVE STRUCTURAL REFORM STRATEGY



SOURCE: Banco de España.

The challenge of addressing inequality

- Levels of inequality in the Spanish economy were already high before the outbreak of the pandemic and, despite the key mitigating role played by public policy, 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.
- 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.

The challenge of addressing inequality
(con'd)

- As far as incomes policies are concerned, further adjustments must be made to the conditions governing eligibility for Spain's minimum income scheme (MIS) to ensure that this instrument can effectively fulfil its mission: to eradicate extreme poverty.
- Steps should also be taken to reduce the adverse effects of inequality in the area of housing affordability, which has tightened in recent years, for both home ownership and rentals.
- 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, this draft Law overlooks certain measures that could give a significant structural boost to the supply of rented accommodation.

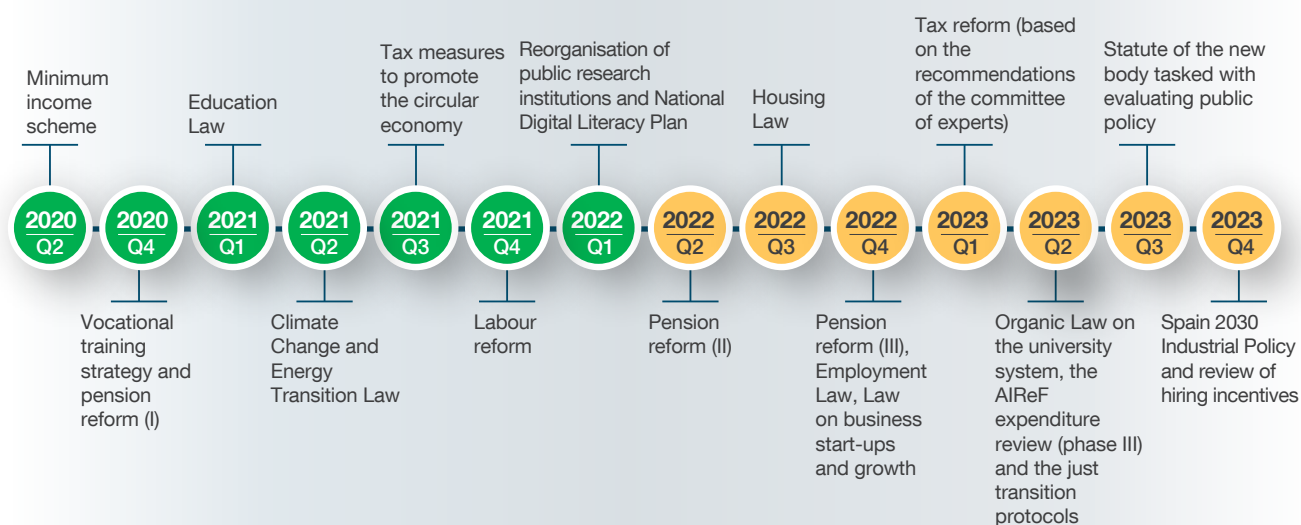
The challenge of increasing firm size and of facilitating cross-sector reallocation

- The small size of Spain's businesses is one reason behind the country's low aggregate productivity.
- It is essential to explore the various reasons why the Spanish business sector is so skewed towards small, low-productivity firms and to mitigate the effects.
- Many of the initiatives that could be rolled out to foster business growth would also facilitate innovation and the processes to reallocate activity across sectors and firms that the Spanish economy will in all likelihood have to face in the coming years.
- One aspect requiring action 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.
- The Draft Law on business start-ups and growth and the Draft Law on developing the ecosystem of emerging businesses represent a step forward in boosting business start-ups and fostering their expansion by improving regulations, removing barriers to economic activity, combating business defaults and providing financial support for business growth.
- Meanwhile, the reform of the Insolvency Law brings in significant changes to insolvency and pre-insolvency procedures and may help partially remedy the shortcomings of the current insolvency mechanisms. Nonetheless, the extent to which some of the new procedures will be effective is unclear.

The challenge of fully capitalising on the roll-out of the Next Generation EU programme

- The rigorous selection of the investment projects to be funded under the NGEU programme is one of the factors that may most influence the success of this mechanism in Spain.
- Some possible improvements to the design of public tenders in a bid to fully harness the transformational impact of the NGEU programme have been proposed by the Banco de España.
- In particular, as part of the criteria for assessing the merits of bids, preference could be given, among solvent, equally productive projects, to those of businesses that find it hardest to access external finance, since some recent studies suggest that this would generate a larger multiplier effect.
- There is a very high degree of complementarity between the financing of investment projects, such as those envisaged in the NGEU programme, and the implementation of structural reforms.
- A recent paper by the Banco de España illustrates how the impact of different combinations of reforms and investment projects associated with the NGEU programme on the Spanish economy's growth capacity in the medium term could vary considerably.

MAIN ACTIONS PROPOSED IN THE SPANISH RECOVERY, TRANSFORMATION AND RESILIENCE PLAN (a)



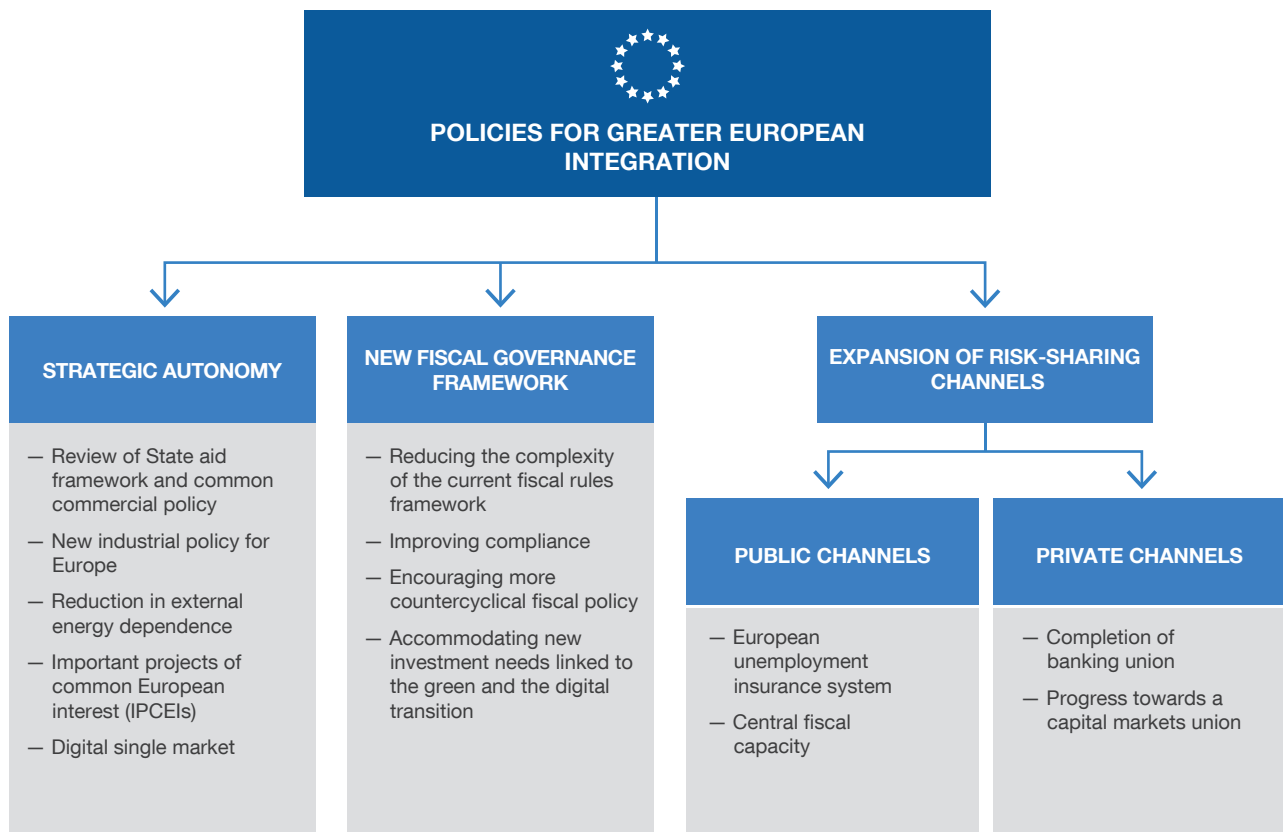
SOURCE: Banco de España, drawing on the Recovery and Resilience Facility Operational arrangements between the European Commission and Spain.

a Reforms already completed are in green, while pending reforms are in yellow.

The fiscal consolidation challenge

- The necessary and resolute response of fiscal policy to the COVID-19 crisis gave rise to a substantial deterioration in public finances in 2020.
- The general government budget balance improved in 2021, albeit largely owing to the cyclical performance of activity. Accordingly, from a structural standpoint, public finances remain highly vulnerable.
- To bolster the sustainability of Spanish public finances, a multiannual 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.
- 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.
- Education and public investment expenditure, two budget items that are essential to drive economic growth and reduce inequality, account for a lower share of Spain's general government accounts than that observed in the European Union overall.
- 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.
- On the revenue side, a comprehensive review of the Spanish tax system is needed to assess whether, overall, the different taxes meet their goals in the most efficient and most effective manner possible.
- The academic literature suggests that shifting the burden of taxation from income to consumption yields potential efficiency and equity gains.
- Any reorganisation of the Spanish tax structure should include a review of the tax cost associated with the consumption tax relief measures.
- The ambitious environmental goals assumed by Spain point to the need to introduce new tax measures in energy, hydrocarbons and transport.
- Moreover, the growing digitalisation and globalisation of economic activity require greater international coordination and harmonisation of the tax system.
- The White Paper for the Reform of the Tax System, published in March, presents a diagnosis of the Spanish tax system and proposes a raft of measures for a future reform of the system.

EUROPEAN POLICIES



SOURCE: Banco de España.

The role of European policies

- European policies are playing an increasingly important role in addressing shocks that affect the EU economies overall, such as the pandemic and, more recently, the war in Ukraine.
- The growing importance of European policies – as an essential factor in Member States' economic activity – means that it is now more important than ever to continue making firm progress to strengthen the European institutional framework.
- Recent trade and geopolitical developments have increased the relevance of the EU's open strategic autonomy agenda. Policies in this area need to be designed and implemented so as to minimise the risk of fragmentation within the EU and undesired distortions.
- The European Commission is currently reviewing the European fiscal rule framework.
- This reform should take into account the magnitude and disparity of the Member States' current budgetary imbalances, which could require a more individualised approach and a reconsideration of the government debt levels that serve to anchor the SGP in the medium term.
- The new European fiscal governance framework should be completed with a number of elements to expand the risk-sharing channels, enabling the risk of financial fragmentation to be reduced and new common investment needs to be financed.
- In addition to expanding public risk-sharing channels, risk pooling among private agents needs to be fostered. To this end, the financial architecture of the European and Monetary Union needs to be completed. In particular, progress is needed on the capital markets union agenda and the banking union must be completed.

<p>The rise in inflation</p>	<ul style="list-style-type: none"> • Since early 2021 inflation has trended upwards globally and has recently reached rates not seen for several decades. • Various factors lie behind this surge in inflation. While global factors are prominent among them, some more idiosyncratic reasons explain why this episode is particularly uneven across the world's major economies. • Although the increase in energy prices is a key factor in the recent surge in inflation rates in the advanced economies, in recent months the price increase has gradually spread to other goods and services and has been reflected in agents' medium and long-term inflation expectations. • The potential materialisation of indirect effects (whereby higher energy costs are ultimately passed through to the price of other goods and services) and of second-round effects (whereby a rise in inflation leads to greater wage increases, which in turn are fed through to product prices) might lead the current inflationary episode to persist. • Beyond the adverse impact that this episode has already had on the main macroeconomic variables, it is having a very uneven impact on different types of Spanish households and firms.
<p>Global factors</p>	<ul style="list-style-type: none"> • The current inflationary pressures are primarily due to the increase in commodity prices and the fact that demand in the major world economies (underpinned by highly expansionary monetary and fiscal policies) has recovered more strongly from the impact of the COVID-19 pandemic than supply (affected, among other factors, by global value chain bottlenecks). • More recently, geopolitical tensions deriving from the Russian invasion of Ukraine at end-February are contributing to a further rise in commodity prices, particularly energy and food prices. • Quantitatively, it is estimated that, in recent quarters, rising commodity prices have been the main factor behind the increase in prices. In any event, the vigorous recovery in demand has also played a very important role in these inflation dynamics, especially in the United States, while bottlenecks have had a particularly acute impact on inflation in the euro area.
<p>Idiosyncratic factors</p>	<ul style="list-style-type: none"> • Despite the eminently global nature of the drivers of the inflationary episode, its impact is proving uneven across the main advanced economies, depending on various factors. • Specifically, once the most severe phase of the pandemic was over, demand recovered particularly vigorously in the United States. This has resulted in stronger and earlier underlying inflationary pressures there. • By contrast, the increase in energy prices is hitting the euro area - especially Spain - harder. This is largely due to the greater share of fuels and electricity in these economies' consumption baskets and also to the depreciation of the euro over recent months.
<p>The spread of inflationary pressures</p>	<ul style="list-style-type: none"> • While energy and food continue to explain most of the current inflation rates, in recent quarters the rise in prices has gradually spread to other consumer items. • Specifically, the proportion of the items in euro area households' typical consumption basket with inflation rates of over 2% has risen from somewhat less than 30% in June 2021 to 80% in March 2022. In the same period this percentage has increased from 25% to 65% in the Spanish economy. • Medium and long-term inflation expectations have also risen. This increase has been sharper in the United States than in the euro area, where in April 2022 inflation expectations remained anchored to the ECB's medium-term inflation target of 2%.
<p>Determinants of the inflationary episode's persistence</p>	<ul style="list-style-type: none"> • After the persistent upward surprises to price dynamics over the course of 2021, the war in Ukraine has triggered a further upward revision to the short-term inflation forecasts. • Despite these stronger inflationary pressures in the short term, analysts continue to expect that inflation rates will ease in the medium term. In any event, these forecasts are subject to considerable uncertainty. • Undoubtedly, price dynamics in coming quarters will hinge decisively on the magnitude and the persistence of the disruptions that the war in Ukraine may entail for economic activity, commodity prices and global production chain bottlenecks overall.

Determinants of the inflationary episode's persistence (cont'd)

- However, other factors may also significantly determine the persistence of the current inflationary episode. Particularly prominent among these factors are the indirect and second-round effects on inflation that may stem from the latest price increases and the economic policy response.

Indirect and second-round effects on inflation

- The rises that have already been observed in the prices of many goods and services could trigger further inflationary pressures in the future via indirect effects.
- How long the price dynamics persist will also depend on the intensity of the potential second-round effects.
- The longer persistence of the inflationary shock makes it more likely that second-round effects will materialise. These second-round effects would be likelier to emerge and more acute were the medium-term inflation expectations to become de-anchored.

The role of an incomes agreement

- The current inflationary episode amounts to an adverse shock to the terms of trade of Spain and the main euro area countries, which are net importers of energy and other commodities.
- Against this background, it is vital that significant indirect and second-round effects be avoided, given that an adverse shock to terms of trade has a greater impact on GDP and employment when such effects materialise.
- In Spain, an incomes agreement between social partners would help avoid a spiral of price and cost increases, which would only exacerbate the harmful effects of the current shock.
- The asymmetric impact of the current shocks on workers, firms and sectors must be considered when determining the specific features of this incomes agreement. It would also be desirable to avoid arrangements that automatically link wages to past inflation or indexation clauses.
- The incomes agreement should likewise include multi-year commitments relating both to wage increases and to job protection. In addition, these wage guidelines should be accompanied by explicit profit margin moderation commitments.

The response of other economic policies

- The fiscal policy response is key to mitigating the effects of the current adverse shock on the hardest-hit households and firms, while simultaneously preventing its persistence over the medium term.
- With this dual aim, the fiscal policy response should focus on temporary compensation measures targeting the most vulnerable households and firms.
- Meanwhile, central banks must continue the process of normalising their monetary policy and avoid a de-anchoring of inflation expectations from their target over the medium term.
- In the current extraordinarily uncertain setting, the ECB has emphasised that its monetary policy response will depend on the performance of economic indicators, in addition to being gradual – provided that euro area medium-term inflation expectations remain anchored around its 2% target – and maintaining all the optionality and flexibility provided by its various instruments.

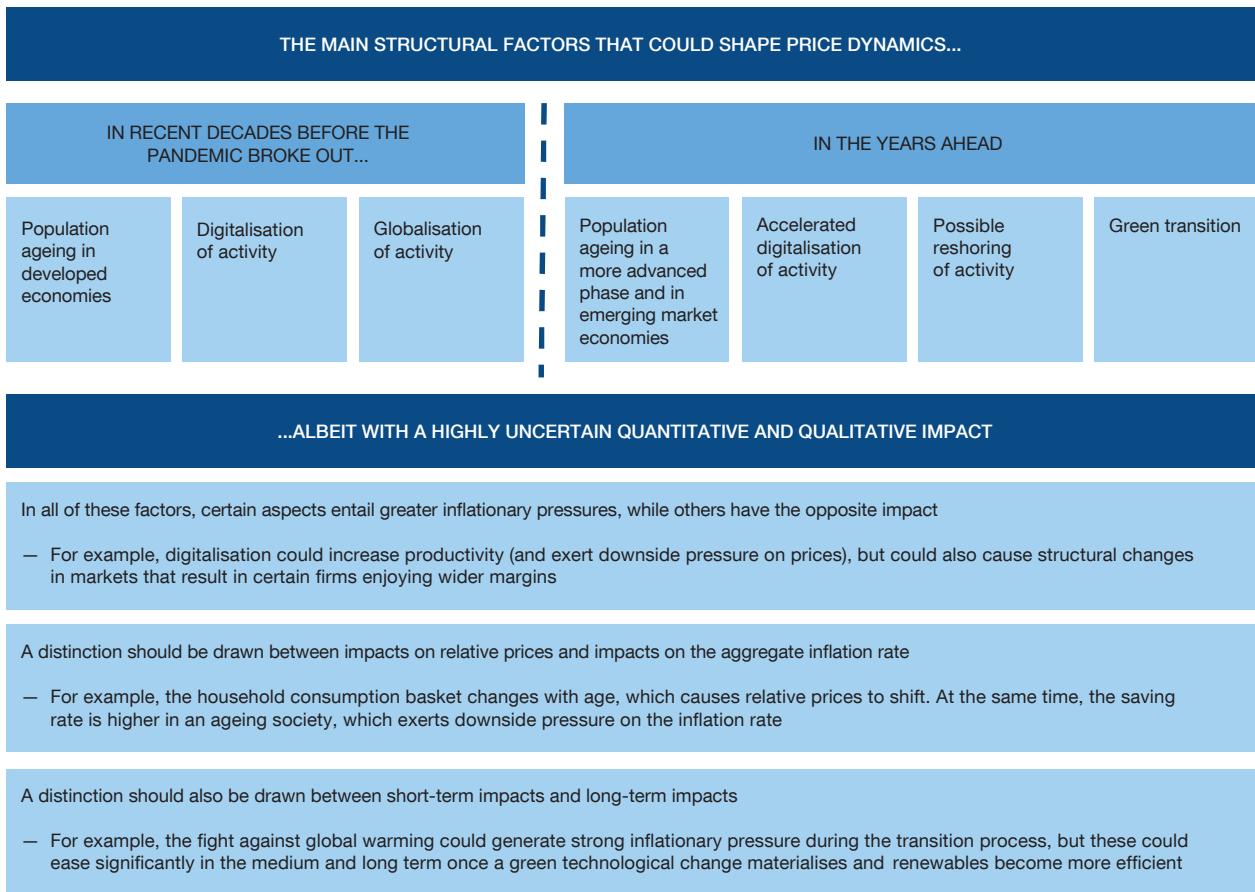
The uneven impact of rising inflation on Spanish households ...

- The increase in prices affects households differently depending on, among other aspects, household structure, age, education, income and net financial position.
- The inflation rate in recent months for lower-income households (bottom quartile) is estimated to be 1.2 pp higher than for higher-income households (top quartile). This owes to staple goods (food, electricity, gas and other fuels), whose prices have recently risen comparatively more sharply, accounting for a larger share of the former's consumption basket.
- Households where the reference person was older than 65 faced inflation 1 pp higher than the rest. This gap is mainly due to the higher inflation experienced by the lower-income households within this group.
- Some of the measures approved in recent months would have an impact on these distributional effects of inflation.

... and firms

- The impact of the inflationary episode is also highly uneven across sectors, depending mainly on how energy-intensive they are.
- The impact of higher energy prices on firms' costs is also magnified by sectoral linkages.
- According to the simulations conducted by the Banco de España, the most affected sectors in the Spanish economy would be air transport, land transport, basic metals and shipping.
- These developments will foreseeably lead to a deterioration of some firms' economic and financial situation. In particular, according to Banco de España estimates, in 2022 the share in employment of firms with negative profitability would rise by more than 3 pp. However, this increase would stand at more than 6 pp in several sectors of activity.
- In addition, within each sector, smaller firms are relatively more reliant on energy inputs, making them more vulnerable to the current inflationary pressures.

INFLATION: STRUCTURAL DETERMINANTS BEFORE AND AFTER THE PANDEMIC



SOURCE: Banco de España.

A global challenge with an extraordinarily uncertain economic impact

- The fight against climate change and the transition towards a more sustainable economy is one of the most important challenges facing Spain.
- The assessment of the economic impact of the various physical and transition risks associated with climate change is subject to enormous uncertainty.
- Nevertheless, there seems to be a certain consensus as to the high costs of not adjusting the current path of GHG emissions and the advantages of an orderly adjustment.
- In view of the magnitude of the climate challenge, all economic policies and agents need to contribute very actively to the green transition.
- Further progress in the fight against global warming will require greater international coordination, while taking into account the specific development conditions of each country.
- Having more high-quality harmonised environmental information is vital if the public policies that will pave the way for the green transition are to be designed correctly. Yet it is also essential for the financial system, to enable investors, credit institutions and central banks to adequately assess both their and other economic agents' exposure to the different climate-related physical and transition risks.

The asymmetric impact of climate change in Spain

- There is consensus among the scientific community that the Iberian Peninsula could be significantly affected by the physical risks associated with climate change, and that this impact would be highly uneven across regions.
- In recent years, similarly to other European economies, Spain has made very significant commitments on the environment.
- Meeting the proposed targets will be an enormous transformational challenge for the Spanish economy overall in the coming years.
- However, beyond the aggregate economic effects that may stem from the fight against climate change, this process will foreseeably have a very uneven impact across regions, sectors, businesses and households.
- In particular, there is evidence to suggest that the physical and transition risks linked to global warming may precisely affect some of the most vulnerable households and firms more severely.

THE ASYMMETRIC IMPACT IN SPAIN OF THE PHYSICAL AND TRANSITION RISKS ASSOCIATED WITH COMBATING GLOBAL WARMING



The Iberian Peninsula could be significantly affected by the physical risks linked to climate change:

- This impact would be highly uneven across regions.
- For example, lower rainfall in the southern part and greater water stress in the south east.



The impact of the green transition will be very uneven at sectoral level:

- Manufacturing, agriculture, transport and electricity and gas supply are the most GHG emitting productive activities in Spain.
- That said, the exposure of a particular sector to climate change does not only depend on its direct GHG emissions but also on its energy intensity and its links to other sectors.



Climate change and the green transition will affect different types of firms unevenly:

- Within each sector, smaller firms seem to be less prepared for climate challenges; many of them have still not assessed the impact these challenges may have on them.
- Among the main risks associated with the green transition identified by firms, higher inflationary pressures and greater administrative burdens (linked to new disclosure requirements) stand out.



The impact of the physical and transition risks may vary considerably from one person to another:

- The foreseeable increase in the prices of more polluting goods and services over the coming years will probably have a greater impact on lower-income households, those whose household reference person is aged 35-45, those residing in rural areas, those with a lower level of education and larger households.
- It would be desirable for public policies to have mechanisms to compensate, temporarily, the most vulnerable households in each of these groups.

SOURCE: Banco de España.

Governments must lead the green transition

- Governments have a leading role to play in the green transition, as they have the necessary democratic legitimacy to establish the roadmap and also the most suitable set of instruments to achieve the proposed climate targets.
- Green taxation is the most efficient means of ensuring that economic agents internalise the climate-related consequences of their decisions. In this respect, green taxes in Spain, which consistently raise a lower share of revenue than in the group of EU economies, must be strengthened and their design improved.
- If used efficiently, the revenue raised by higher environmental taxes could significantly reduce the transition costs for the economy overall.
- Public investment and subsidies to encourage private investment are also key levers for driving the green transition. In this respect, fully harnessing the transformational capacity of the NGEU programme in Spain is vital, with a rigorous selection of the investment projects to be funded and roll-out of an ambitious structural reform package.
- Compensatory measures must be deployed to ease the markedly asymmetric impact of the green transition on different types of industries, firms and households. These measures should be essentially temporary, concentrated on the most vulnerable and hardest hit groups, and should be designed so as not to undermine the incentives to reduce pollutant emissions.
- Meeting the environmental targets proposed without wasting resources, and avoiding any unwanted effects on activity, calls for the ongoing assessment of public policies.
- Moreover, in the midst of such an extraordinarily uncertain structural transformation process, it is essential that public policies provide certainty to the different economic agents, while facilitating a stable operational framework within which they can make their consumption, investment and production-related decisions with every assurance.

The financial system also has a key role to play in the climate challenge

- Without the active involvement of the financial system, it will be impossible to efficiently channel the large volume of funds needed to develop new green technologies and to enable households and firms to adopt them across the board.
- All financial system and capital market participants must be able to accurately identify the extent to which they and the other economic agents are exposed to the various physical and transition risks associated with climate change, and to actively factor such information into their risk management.
- Looking ahead, the continued progress of sustainable finance will critically depend on improvements to the information available, on the headway made in defining international standards and on the ex post verification of the commitments undertaken by the issuers of sustainable instruments.

Central banks – within their mandates – must also contribute to the green transition

- Climate change and the transition to a more sustainable economy are also a considerable challenge for central banks.
- These processes of structural change could significantly affect monetary policy conduct, pose considerable risks to financial stability and call for a resolute response in terms of both banking regulation and prudential supervision.
- Accordingly, although this process is at an admittedly incipient stage, the world's main central banks have begun to factor in climate change and green transition-related considerations when determining and implementing their monetary policy.
- In the financial stability arena, stress tests for adverse weather events have recently begun in collaboration with credit institutions. In this respect, the Banco de España's top-down analysis shows that climate risks will have a moderate impact on the Spanish banking sector in the short term.
- Also, in the area of regulation and prudential supervision, work is under way to ensure that credit institutions are ready to identify, measure, manage and properly report the financial risks associated with climate change, thus contributing to the green transition.

THE ROLE OF KEY ACTORS IN THE FACE OF THE CLIMATE CHALLENGE...

 GOVERNMENTS	 FINANCIAL SECTOR	 CENTRAL BANKS
<ul style="list-style-type: none">– Increasing green taxation and boosting public investment– Deploying compensatory measures to mitigate adverse effects on the most vulnerable groups– Setting environmental standards to enhance the regulation of economic activity– Providing economic agents with certainty and a stable operational framework	<ul style="list-style-type: none">– Efficiently channelling the enormous volume of funds that needs to be invested in the green transition– Properly assessing its own and other economic agents' exposure to climate risks– Developing and harmonising new financial instruments	<ul style="list-style-type: none">– Incorporating climate considerations into their monetary policy operational frameworks– Monitoring the risks to financial stability posed by climate change and the green transition– Enhancing the regulation and prudential supervision of climate risks

... IN A CONTEXT IN WHICH...

 Extraordinary uncertainty surrounds the economic impact of climate risks	 Achieving a high degree of international coordination is necessary	 Increasing the quantity, quality and harmonisation of environmental information is essential	 Reviewing public policies continuously and rigorously is more important than ever
----------------------------------------------------------------------------------------------------------------------------------------------------------------	----------------------------------------------------------------------------------------------------------------------------------------------------------	------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------	---------------------------------------------------------------------------------------------------------------------------------------------------------------------------

SOURCE: Banco de España.

