Since our last report was published, the risks to financial stability have increased, owing to the geopolitical tensions and to higher and more persistent inflation. These factors have already led to a significant slowdown in activity. Against a backdrop of high uncertainty, the economic growth projections for 2023 have been revised down and those for inflation up, and the likelihood of a global recession has increased.

To date, the main economic effect of Russia's invasion of Ukraine has been the rise in commodity prices, especially energy and food commodity prices. In consequence, inflationary pressure has stepped up significantly, especially in Europe. However, price increases above the inflation target of 2% have already spread to a large part of the consumption basket, beyond the goods and services most linked to energy and food. The European Central Bank, like other central banks, is tightening its monetary policy with the aim of reverting to the inflation target in the medium term and of preventing the current inflation surge from feeding through to agents' expectations. Significant progress is thus being made in withdrawing the accommodative stance of monetary policy.

The combination of higher inflation and lower-than-expected economic growth, and rising interest rates, is adversely affecting households' and firms' ability to pay, especially among the most vulnerable segments, which are characterised by low income levels, greater dependence on energy and food products as a proportion of their income and, in some cases, high indebtedness. Should the materialisation of risks lead to further deterioration in activity and in financing conditions compared with current expectations, these agents could face greater difficulties in meeting their financial commitments.

Bank financing costs have held relatively stable for firms and households in 2022 to date, as the rise in market interest rates has only been passed through partially – and by less than in the past. A more marked increase was seen in the cost of corporate financing on wholesale markets, partly because of higher corporate risk premia. The financing costs of the non-financial private sector are expected to increase further insofar as interest rate rises continue and gather pace and it becomes necessary to roll over corporate debt at shorter maturities, while floating-rate mortgage prices are revised.

Under these circumstances, financial markets have continued to operate in an orderly fashion. However, the risk premia for different asset categories have risen since the start of the Russian invasion of Ukraine, and volatility has increased. Individual instances of lack of liquidity in some financial market participants and collateral shortages have also been observed, while the liquidity indicators in some key markets, such as the sovereign debt market, reflect less abundant liquidity. More abrupt financial market corrections could arise if geopolitical tensions and economic uncertainty continue or intensify. This would drive up financing costs for sovereign debt, financial institutions and large firms in wholesale markets, which would also exert upward pressure on the cost of retail financing.

There is also some concern worldwide about certain open-ended investment funds that have accumulated risk exposures in recent years and have very tight liquidity positions. In Spain investment funds have more comfortable liquidity positions. Nevertheless, both these and other Spanish financial intermediaries and, in particular, the banking sector, may be adversely affected by global financial market corrections triggered by the potential stress associated with the procyclical behaviour of these funds.

In this setting, the high level of public debt is a vulnerability factor. Accordingly, fiscal support should be temporary, should be focused on the segments hardest hit by the energy crisis and should be complemented by a medium-term fiscal consolidation programme to bolster the sustainability of public finances. The application of an across-the-board fiscal stimulus in a high-inflation setting would entail the risk of generating second-round effects on inflation, with future negative consequences for growth too.

The real estate sector maintains a degree of dynamism in transactions and price growth, with some moderate signs of overvaluation since 2020. However, the latest data suggest that tighter financial conditions are beginning to temper activity in this sector. In any event, the Banco de España will continue to closely monitor the real estate market situation because, although mortgage loan origination has also slowed somewhat, certain mortgage segments have relatively high loan-to-income ratios and a squeezing of interest margins on new fixed-rate mortgages has been observed.

The Spanish banking sector is facing this situation with profitability above its cost of capital, NPL levels that continue to decline and solvency higher than before the onset of the health crisis. Nevertheless, the worsening of the macro-financial environment may have a significant adverse impact on banks’ income statements and capital. Against this backdrop, the temporary levy proposed by Parliament would reduce the sector’s ability to generate income, with potential implications for solvency if the set of risks identified in this report materialise strongly.

The Banco de España’s simulation exercises on macroeconomic scenarios show that the Spanish banking sector as a whole is substantially resilient, albeit with some heterogeneity across banks. The increase in interest rates under these scenarios has positive effects on bank profitability in the short term, through higher net interest income. However, in the medium term it would also contribute to negative effects materialising, mainly through higher provisioning costs. Under a particularly severe scenario, there would be significant capital depletion, as the above-mentioned negative effects would predominate, but aggregate solvency would remain at an adequate level.

In a scenario as complex and uncertain as the current one, banks should exercise extreme prudence in their provisioning policies, taking into account the likelihood of the risks identified materialising. They should also be very cautious in their capital planning, since the pandemic crisis has proven that the level of solvency is essential for banks to continue to seamlessly perform their role as intermediaries of loanable funds in the economy. Against this background, the Banco de España has decided to hold its macroprudential policy unchanged, thus avoiding any procyclical measures that might prompt an adverse effect on lending and activity.

The assessment of high risks to financial stability and the need to adapt macroprudential policy to the macro-financial conditions specific to Spain are consistent with the European Systemic Risk Board (ESRB)'s warning of 22 September 2022 on vulnerabilities in the EU financial system.