Some of the risks to financial stability have eased over the last six months. Lower energy prices and the resilience of aggregate demand have meant that economic activity has slowed less than expected and, in the case of energy prices, that inflation has also fallen considerably. Overall, these developments have staved off an economic contraction. However, uncertainty remains extraordinarily high.

First, heightened geopolitical tensions still threaten to undermine investor confidence and may contribute to the crystallisation of blocs, with adverse effects on global financial and trade flows. Specifically, they pose risks in terms of higher energy and other commodity price levels and volatility. Indeed, the oil output cuts announced by OPEC+ have accentuated these risks in the short term.

Underlying inflation remains high in several geographical areas and also increases the risks of second-round effects on wages and profit margins, which could intensify the inflationary dynamics and make them more persistent. This would, in turn, require a more forceful monetary policy response and would raise the costs of financing for households and firms.

Banking sector turmoil in March, as a result of serious financial problems at Silicon Valley Bank, other medium-sized US banks and Credit Suisse, has driven the banking sector's stock prices down and increased the risks to liquidity and financing costs.

The euro area banking sector and, particularly, the Spanish one are facing these market tensions from a highly resilient position and with sound overall capital and liquidity positions. Spanish banks' gearing towards the retail segment positions them favourably vis-à-vis this risk environment, due to this business model's greater resilience to shocks to liquidity supply and wholesale funding costs.

Nevertheless, the materialisation of the different macroeconomic and financial risks identified, particularly if they did so simultaneously, would significantly raise the cost of bank financing and, in the more medium term, erode their customers' servicing capacity. All these factors would limit credit supply. Thus, against such a highly uncertain backdrop, Spanish banks must implement a prudent provisioning and capital policy that takes advantage of their favourable positioning and uses part of the higher earnings they are currently generating to further bolster the sector's resilience and keep lending flowing in the event of episodes of stress.

Should they materialise, the potential shocks to energy markets and financing conditions would also negatively impact the growth of activity, which would

increase the adverse effects on different economic agents' income and worsen their financial situation.

In this respect, the high level of public debt is a vulnerability and requires that fiscal consolidation, which would provide more room for manoeuvre in response to future shocks, begin now in 2023. This process should be sustained over time — in order to correct structural elements of the deficit, which are also estimated to be high — and adapted to macroeconomic developments. In assessing Spain's budgetary position, it should also be borne in mind that fiscal costs will be mitigated by the use of NGEU funds and that the deactivation of the general escape clause of the Stability and Growth Pact in 2024 will mark the reintroduction of fiscal rules in Europe.

Turning to the private non-financial sector, profit margins and wages both performed positively in 2022, with employment growing considerably. In any event, some heterogeneity across sectors and firm sizes has been observed and some of the buffers previously built up have been depleted. As monetary policy tightening is passed through to the costs of bank lending, the proportion of firms and households under high financial pressure can be expected to increase, even if bank deposit rates also start to climb.

Against this backdrop, at end-2022 the 2012 Code of Good Practice (CGP) — which focused on smoothing forbearance for vulnerable mortgagors — was amended, a new temporary CGP was implemented so that potentially vulnerable households had more time and were better able to adapt to the new interest rate environment, and additional measures were approved so that all households could more easily switch the variable rate on their mortgage to a fixed rate and also repay their debts early.

Coordinated arrangements for the forbearance of the debt of the most vulnerable households may make debt collection all the more likely and mitigate the potential impact of higher rates on consumption. However, these measures also have costs, such as household indebtedness being higher for longer and their access to credit potentially being limited in the future.

Real estate market prices continue to show some signs of being overvalued, but the tightening of financing conditions, which is already considerably slowing house purchases and the flow of new mortgage lending, could lead such prices to be corrected in the coming quarters.

There continues to be no evidence of any build-up of systemic imbalances in credit to the private sector in Spain. In fact, the credit-to-GDP gap adjusted for the financial cycle in Spain has fallen below the activation threshold of the countercyclical capital buffer (CCyB), as anticipated by its downward trend since 2021. The return to normal economic activity in 2021 and 2022 has reduced the

negative output gap, although the improvement slowed down in 2022 H2 owing to less buoyant activity. In addition, the recent financial turmoil means uncertainty remains high. In light of all the above, the Banco de España is holding the CCyB at 0% and has not activated any other macroprudential measures.