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Appearance by the Governor of the Banco de España before the Parliamentary Economic Committee

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Ladies and gentlemen,

I would like to begin my first appearance as Governor of the Banco de España before this chamber expressing my sincere gratitude for the comments made by the Parliamentary group representatives about me when the former Minister for the Economy, Industry and Competitiveness – Román Escolano – put forward my proposed appointment to the house. Likewise, I particularly value all your suggestions and opinions about the functioning and mission of the Banco de España. I take these suggestions as a spur to enhance my work, which I undertake to perform with full independence, as the Law of Autonomy obliges me to.

To this end, I should like to seize this occasion to announce that the Banco de España has begun work on an ambitious strategic planning project for the coming years. Under a comprehensive and forward-looking approach, the project will address most of the issues raised here, along with other matters we consider essential so that our central bank may better perform its functions and be of greater value to society, in the context of the Eurosystem and the new economic governance of the euro area.

As I said when I officially took up office, the main objectives are to increase the presence and influence of the Banco de España at the European and global levels, and to reinforce its early-warning capacity regarding identification of the vulnerabilities and risks to the Spanish economy's financial and macroeconomic stability, as well as its responsiveness in mitigating these risks and preventing their materialisation. In short, we aspire to a more open and transparent institution, and one more flexible and efficient, that harnesses its human and material resources to the full, under the guiding principles of independence, intellectual rigour and excellence.

Following this introduction, allow me to turn to the central purpose of this appearance. As you know, in late May the Banco de España published its *Annual Report,* which reviews economic and financial developments in the Spanish economy, and in the European and international environment, together with the main challenges and vulnerabilities facing it.

The *Annual Report* is the Banco de España's main publication in respect of its functions as the monetary authority and adviser to the Government on economic policies. Accordingly, I would like to begin by summarising the main aspects of the current situation of the Spanish economy and its external environment, along with its short and medium-term risks, moving on subsequently to describe the challenges our country faces over a longer horizon.

External environment

As regards the external environment, the global economy has, so far in 2018, shown signs of slowing, following the high growth recorded in 2017 (see Chart 1). Less easy global financial conditions (which have translated in the case of some emerging economies into major financial tensions), heightening protectionism (in particular with the escalation of tariff-related tensions between the United States and China), and increased geopolitical uncertainty at the global and European levels, are some of the main factors behind this slowdown.

Contributing to the tightening of global financial conditions has, among other factors, been the progressive normalisation of the US Federal Reserve's monetary policy, which is progressing at a swifter pace than in other areas given the relatively advanced position of the United States in its economic cycle. To date, it is the countries with greater vulnerabilities in terms of external and foreign-currency financing needs (as is the case of Turkey and Argentina) that have mainly been affected.

Global inflation, which remained contained in 2017, has risen but gradually in the first half of 2018, despite the increase in oil prices. In the advanced economies, core inflation remains relatively moderate (see Chart 2).

In the euro area, following a robust expansion in 2017 (see Chart 3), the economic slowdown is proving more pronounced than what was projected some months back and, moreover, it has spread to most countries in the area. Against this backdrop, there has been a notable loss of dynamism in exports and, on the internal front, increased political uncertainty in Italy, which is significantly affecting this country's sovereign debt markets; that said, the effects on other euro area markets have been limited so far.

Further, the risks to global growth have stepped up. Such risks include most notably those derived from the increase in protectionist policies, from the growing vulnerability of certain countries and agents to a potential further adjustment to global financial conditions, and from the possible heightening of geopolitical tension in certain hotspots. In addition, in the European arena, the outcome of the Brexit and the direction of Italian economic policies are major areas of uncertainty. These developments, along with the increase in global risks, might ultimately affect the growth outlook for the euro area as a whole and, therefore, for the Spanish economy.

The economic expansion in the euro area has not been accompanied to date by an across-the-board and sustained acceleration in prices (see Chart 4). In this respect, the recent rise in inflation, to 2.2 % in October according to the latest leading indicator published today, is essentially due to the increase in the cost of energy, while the more stable components continue to post low rates of increase.

That said, the intensity of job creation and the progressive reduction in the degree of labour market slack in the euro area economies are prompting a gradual rise in wages. Should this continue over time, it would contribute to a sustained pick-up in inflation towards rates closer to the Eurosystem's medium-term price stability objective, consistent with an inflation rate lower than, but close to, 2%.

Recent developments and outlook for the Spanish economy

Turning to the Spanish economy, so far in 2018 the expansionary phase has continued, albeit at a lesser pace than in previous years. Real GDP growth stood at 2.5% year-on-year in the third quarter, following increases equal to or higher than 3% in the three preceding years (see Chart 5).

This slowdown in growth, which the Banco de España has been anticipating in recent quarters, is partly in response to the international environment, where developments have been somewhat less positive this year, as I previously described. In any event, the baseline scenario for growth in the Spanish economy in the coming years is consistent, as it is in the euro area as a whole, with growth rates running above potential and, therefore, with an increasingly positive output gap.

As to consumer prices, the dynamics continue to be greatly affected by the fluctuations in the energy component (see Chart 6). The latest available figures, for October this year, show a year-on-year increase in the overall harmonised index of 2.3%. However, core inflation remains moderate, at around 1%. As from the final stretch of the year, a progressive reduction in the contribution of the energy component is projected, which will tend to be offset by the gradual strengthening in the core component, in step with the foreseeable widening of the positive gap between actual and potential output.

Spanish economic activity continues to be underpinned by easy financial conditions. The maintenance of the accommodative monetary policy stance is allowing the average interest rates on bank lending to hold at levels close to their historical lows. Also, the financial position of households and firms has continued to strengthen in the course of 2018.

In tandem, private consumption has held at a growth rate which, though it has slowed during this year, remains high and is outpacing the increase in real disposable income, which has led the saving rate to ease to historically low levels (see Chart 7). Looking ahead, however, the room for household saving to further contract appears limited.

Investment by non-financial corporations has continued to expand (see Chart 8). As in the case of households, financing conditions, in terms both of cost and availability of funds, have remained conducive to companies taking spending decisions, as has the strengthening of their financial position.

Maintaining the momentum of investment is pivotal, given that productive investment is a fundamental determinant both of the cyclical dynamics of the economy and of long-term economic growth.

A characteristic feature of the current expansionary cycle has been the compatibility of economic growth with a significant external surplus (see Chart 9). Various factors have contributed to sustaining this surplus, including most notably the significant increase in the base of firms that export their products regularly, the increase in revenue from the tourist industry, despite its recent slowdown, and the environment of low interest rates, which has contributed to diminishing the income balance deficit. However, looking ahead, some of these factors will foreseeably lose steam, owing partly to the effects of the appreciation of the euro, in nominal effective terms, and to dearer oil. These effects will give rise to a considerable reduction in the Spanish economy's net lending vis-à-vis the rest of the world, which is nevertheless expected to remain positive over the coming years.

With regard to the labour market, 2.3 million jobs have been generated since 2013. These developments, along with the reduction in the labour force as a result of population ageing, have enabled the unemployment level to be reduced most significantly. The unemployment rate thus stands below 15%, 12 pp down on its 2013 high (see Chart 10), although still far off the level observed in the euro area on average (slightly above 8%). Most recently, the robustness of employment has eased in line with developments in activity, making for continuing and very low growth in productivity, as has been the case since the start of the recovery.

Strong job creation has been accompanied by a modest increase in wage compensation in the past four years. Chiefly contributing to this has been the high degree of slack in the labour market which dates back to the start of the current pick-up, and the expectations of very low inflation rates during these years. In any event, and in line with the current recovery phase, wage settlements under collective bargaining agreements have risen from 0.6% in 2014 to the current level of 1.7%, on cumulative data to September. This improvement will foreseeably continue in the future, in line with the recommendations of the Employment and Collective Bargaining Agreement, signed by the social agents on 25 June and in force over the next three years, which promotes wage increases of 2%, plus a variable amount of 1% conditional upon different sector-based macroeconomic concepts. The variable elements in collective bargaining should be viewed favourably, insofar as their application caters for firms' specific circumstances, such that wage developments are adjusted as much as possible to labour productivity.

Main factors of risk in the short and medium term

The outline I have offered on the foreseeable course of the Spanish economy is not free from risks. And should such risks materialise, they might adversely affect economic growth.

On the external front, as earlier stated, are the uncertainties associated with the effects of monetary policy normalisation (in particular in the United States) on global financial conditions. Other factors of concern are the possible resurgence of geopolitical tensions or a potential escalation in the adoption of protectionist measures. Specifically, the outcome of Brexit and the situation in Italy are of particular significance for the Spanish economy.

In the domestic arena, the parliamentary fragmentation that has characterised national politics in recent years also generates uncertainty over the course of some of the main economic policies, in relation both to the necessary process of budgetary consolidation and to the likewise much-needed adoption of new structural reforms enabling the economy's growth potential to be increased. Moreover, a further rise in uncertainty, associated with the political situation in Catalonia, continues to pose an additional risk to economic stability, especially in the Catalonian region.

Achievements and limits of the recovery

The Spanish economy has completed a growth phase of five years. Specifically, since end-2013, GDP has grown by 14% in cumulative terms, having exceeded since mid-2017 its pre-crisis level. Some of the structural reforms launched during the recession will have contributed to this recovery. These include, on the domestic front, the labour market reform, the restructuring and clean-up of credit institutions, pension system reforms and the headway in fiscal consolidation. And at the European level, we may mention the various measures approved in recent years, including most notably the start-up of the Banking Union.

Yet a series of more transitory – though persistent – factors has also contributed decisively to the momentum of the recovery. These factors include the role played by the ECB's monetary policy and the implementation of an expansionary fiscal policy in recent years, combined with the significant reduction in oil prices from mid-2014 to early 2016 and, subsequently, the improvements in external markets.

In respect of monetary policy, the various ECB measures have allowed financial conditions to be eased considerably, and have acted as a mainstay for the economic recovery in the area, contributing to countering the deflationary trends looming over the region some years back. For the Spanish economy, it is estimated that from 2014 to 2018 the ECB's measures boosted real GDP by 2.3% and the CPI by 1.4% (see Chart 11). These effects are of a fairly similar magnitude to those estimated for the euro area as a whole (2.3% and 1.7%, respectively).

The fiscal policy stance shifted from expansionary in 2015 and 2016 to neutral in 2017, but it will once again be expansionary in 2018 once the various measures included in the State Budget for this year materialise. Over recent years, the reduction in the deficit has been due to the economy's cyclical improvement and to the fall-off in interest expenditure, while the structural deficit has held at still-high levels, according to the European Commission's latest estimates.

That said, the role of the foregoing factors should, in future, tend progressively to taper off. This has been the case already for oil prices, the course of which has reversed since mid-2017, and, to a lesser extent, of external markets, following the recent slowdown. But it is particularly relevant for demand-side (monetary and fiscal) policies.

Specifically, it is to be expected that monetary policy will progressively play a less pivotal role. With the advance of the euro area economy's position in the cycle, according to the ECB's latest estimates, there will be a progressive pick-up in inflation levels to close to 2% in the coming years. Indeed, at its meeting on 14 June, the ECB's Council reached the conclusion that the progress to date towards a sustained adjustment of inflation has been substantial, which gave rise to a gradual reduction in net asset purchases, duly confirmed by subsequent successive meetings of the Governing Council. The anchoring of long-term inflation expectations, the sound underlying firmness of the euro area economy and the maintenance of a high degree of monetary accommodation offer reasons to believe that the sustained convergence of inflation on the Governing Council's objective will continue in the coming months, and that it will be maintained even after the finalisation of the net purchase programme, in line with the – very gradual – normalisation of monetary policy announced by the ECB's Council.

Fiscal policy should resume the fiscal consolidation process, given that both the public debt/GDP ratio and the structural deficit are holding at levels some distance off the limits set in the Stability and Growth Pact (see Chart 12).

In recent years notable headway has been made in correcting some of the imbalances in the Spanish economy, such as the restructuring of the financial system, private-sector deleveraging, the recovery in competitiveness and the attainment of persistent current-account surpluses, and the adjustment of the real estate sector. However, the progress in correcting other imbalances has been more meagre and the economy retains significant elements of vulnerability. These include most notably high public indebtedness, running close to 100% of GDP, and the nation's still-high net debtor position, despite the aforementioned current account surpluses. Substantial structural dysfunctions also persist in the labour market, as illustrated by the still-high unemployment rate, and a growth pattern more intensely conducive to high-productivity activities generating high value added has yet to definitively take root. And this against a background in which population ageing will significantly reduce the economy's potential growth, while imminently posing far-reaching challenges in public pensions. Moreover, the banking system still has significant challenges ahead, which I shall refer to later.

In the setting described, characterised by the gradual loss of momentum of the effects of demand-side policies, it is particularly desirable that the measures aimed at correcting these vulnerabilities should take the lead, thereby supporting medium and long-term growth. The current juncture of economic expansion should be harnessed to make the necessary reforms and gain budgetary room for manoeuvre to face adverse cyclical situations in the future.

Allow me to focus now on each of the challenges mentioned and the potential economic policy responses.

Challenges facing the Spanish economy

First, regarding fiscal policy, let me stress that maintaining high public debt over a prolonged period may have negative effects on economic growth: it raises financing costs for the economy; it makes it necessary to run substantial primary surpluses that demand higher tax levels or lower levels of productive spending; it lessens the room for countercyclical fiscal policy measures to address potential adverse shocks; and it is a source of vulnerability in the face of changes in market investor sentiment.

Accordingly, resuming fiscal consolidation is a priority, so as to enable the progressive reduction of the public debt/GDP ratio and of the structural deficit, in line with the demands of European and national fiscal rules.

The fiscal consolidation process should, moreover, be compatible with an improvement in the quality of public finances. The adjustment needed should be anchored in a medium-term programme in which the measures allowing the attainment of budgetary objectives should be spelt out, along with a prudent macroeconomic and public revenue forecast. Furthermore, the composition of the adjustment takes on particular importance, as it should be conducive to a greater contribution of public finances to the economy's potential growth.

Population ageing is also a challenge of the highest order for the sustainability of public finances. Specifically, the latest estimates of its impact on public spending on pensions, health and long-term care reveal a significant increase in expenditure on these areas over the next three decades. In the case of the pension system, the 2011 and 2013 reforms included a progressive raising of the retirement age, the application of the sustainability factor, which links the initial pension to the increase in life expectancy, and an annual revaluation index for pensions, with their increase conditional upon the system's revenue and expenditure being in balance. These reforms were geared to gradually correcting the system's current shortfall, significantly countering the effect of the expected increase in the dependency rate in the long term.

However, the latest legislative developments appear to be moving towards relaxing the application of the current re-balancing mechanisms, the sustainability factor and, above all, the annual revaluation index for pensions. A return to inflation-indexed pensions would, on Banco de España calculations, give rise to an increase in public spending of over 3 pp of GDP in 2050 compared with the scenario based on the strict application of the revaluation index. Ensuring the system's financial sustainability would therefore require including additional measures on the revenue or on the expenditure sides of the system. In any event, it is desirable that any reform strategy chosen should increase the system's transparency, strengthen its contributiveness (i.e. the relationship between contributions and benefits) and, in particular, maintain an automatic adjustment mechanism that ensures the sustainability of the population's future pensions.

It is likewise important to recall that the impact of population ageing is not confined to public finances, since it also bears down on the participation rate, productivity and the economy's potential growth; hence, tackling this phenomenon calls for a broad-brush approach, regarding both the time period envisaged and the set of instruments that should be used.

In this respect, the outlook for the Spanish economy's long-term potential growth is relatively modest (see Chart 13). Specifically, on the latest available estimates, which are naturally subject to some degree of uncertainty, our economy's potential growth rate is expected to fall from close to 3% per annum in 2008 to post-crisis levels slightly below 1.5%. This level, though close to that of the euro area, is below that estimated for the most dynamic developed economies. Among the key structural factors constraining this growth are the aforementioned population ageing, high structural unemployment and lacklustre productivity.

Indeed, despite the swift pace of job creation in recent years, unemployment remains very high, especially among certain groups, such as the lesser-skilled, whose unemployment rate is over 25% (see Chart 14). The difficulties some groups face in finding work means that, according to figures for the third quarter of 2018, practically half the unemployed have been in this situation for over a year. Of particular importance here is improving the quality of employment, which is affected by the high involuntary part-time status and short duration of employment contracts. Such marked segmentation of the labour market hampers, moreover, productivity gains.

These market inefficiencies also lie behind – at least in part – the changes in inequality in Spain during the crisis. Over the course of the Spanish recession, strong job destruction, concentrated among certain groups, and the precariousness of many contractual relationships that arose from this more uncertain macroeconomic setting prompted growth in inequality in per capita income, despite the fact that wage differences among workers oscillated less than in other developed economies. The current upturn and, in particular, strong employment creation are allowing some correction of per capita income inequality. However, looking ahead, additional reductions in the indicators of income inequality will depend on continuing reductions in unemployment, which requires improvements in the employability of the lesser-skilled and an increase in the hours actually worked by employees with lower wages. In any event, the causes behind the dynamics of inequality and its effects are complex, and learning about them will involve analysing in depth the various key facets (wages, household income, consumption and wealth, among others), this being an essential requisite for designing public policies conducive to socially sustainable growth.

Against this background, allow me to refer to the discussions surrounding the national minimum wage. The *Annual Report* mentions the effect of the increases approved in 2017 and 2018, of 8% and 4%, respectively. In this respect, the empirical evidence available on the effects of increases in the minimum wage offers a wide variety of results, although in general, it tends to suggest that an increase in the minimum wage has a negative – although limited – effect on aggregate employment in the economy. Nonetheless, according to this same evidence, the impact on the probability of job loss is significant in the case of certain groups, such as lesser-skilled youths and elderly workers, whose unemployment rate is still very high and whose level of productivity is below the average. The level of the national minimum wage and its annual increases should therefore be designed bearing in mind the productivity of the workers affected and their level of employability if it is wished to avoid undesirable effects, in the form of job loss and increased inequality.

To address the challenges of our labour market, economic policy should firstly move on evaluating active policies, especially among the lesser-skilled, in order to focus resources on those measures most effective with a view to increasing employability. Secondly, future changes in the labour market should serve to make progress in reducing temporary employment and excessive job turnover, without hindering job creation and, in particular, permanent job hires. Thirdly, mechanisms should be set in place to provide for a greater alignment of each firm's wage conditions with their level of productivity. Also, it should be sought to enhance work-life balance, to promote the birth rate and to tailor migratory flows to the demand for specific professionals and job profiles. Finally, as I said regarding the minimum wage, the measures aimed at protecting the lowest incomes should be designed in such a way as not to diminish employability.

Meanwhile, the factor productivity growth rate of the Spanish economy continues to be low (see Chart 15). The modest growth of productivity has been associated with a lower rate of growth of firms' average productivity in Spain than in other European countries, and with an allocation of resources to less productive firms during the past expansion. Addressing these problems requires an improved business competition framework.

Regarding this last matter, over the last decade much of the loss in competitiveness – measured in terms of relative unit labour cost indicators – accumulated during the expansionary phase relative to the euro area as a whole (see Chart 16) has been recovered. This improvement is mainly explained by the improved labour productivity associated with severe job destruction during the crisis and by wage moderation, while the correction associated with profit margins has been less important. This fact, which at first may have been associated with the need for firms to improve their financial position, may now be evidencing a certain lack of business competition in some sectors, the persistence of which may hinder the proper allocation of resources, incentives and innovative capacity and, in general, the well-being of consumers.

In order to foster an adequate level of competition, apart from lowering the barriers to entry in some sectors, certain regulations hampering the development of new productive firms will have to be reviewed, either because they provide incentives contrary to the development of business growth or because they hinder the exit from the market of firms with sub-optimal productivity, thereby limiting the proper allocation of productive resources in the Spanish economy.

Additionally, enhanced productivity requires improvements in human and technological capital. In this respect, the educational legal framework needs to be strengthened, to eliminate the gap between the educational quality indicators of Spain and other developed countries, and the challenges to Spain's educational and occupational training system posed by globalisation, technological process and task automation need to be addressed without delay.

Furthermore, during the crisis the technological capital gap between Spain and its European partners widened due to lower spending on R&D as a proportion of GDP in the public and, particularly, the private sector. In addition to the structural features limiting firms' innovative ability (in terms of human capital, business capabilities, productive structure, business competition and financing), Spain's public research system is susceptible to improvement and the budgetary funding of innovation is low.

Challenges facing the Spanish banking sector

Let me now concentrate on some of the main challenges facing the Spanish banking sector. Despite the significant progress made in recent years in terms of profitability, solvency and liquidity, it still faces some significant challenges, largely shared with other euro area banking systems. Overcoming these challenges is vital if Spanish banks are to build up a sufficiently strong position to contribute to economic growth and job creation.

The first of these challenges is to reduce the assets impaired by the crisis. Chart 17 shows that in June 2018 the volume of non-performing assets had decreased by 60% from its peak, although it remained at still-high levels. Foreclosed assets had fallen by 40%. Economic growth will continue contributing to the ongoing reduction of impaired assets. However, banks need to press ahead with applying active management policies to their impaired assets. In this respect, it should be kept in mind that continued high levels of impaired assets have deleterious effects on banks themselves and on the economy as a whole, which is why the economic and supervisory authorities have a special interest in banks taking appropriate measures in this area.

Recouping profitability is another of the challenges facing the Spanish banking sector. Although Spanish bank profitability has returned to positive levels and stands somewhat above the EU average (as shown by Chart 18), it is still below its pre-crisis levels and below those of the banking systems of some developed economies which have performed better in this respect. This current low profitability is concentrated in banks' business in Spain, although their activity abroad, which provided them with a valuable source of risk diversification during the crisis, is not plain sailing, particularly at present when some of the economies to which Spanish banks are exposed (such as Turkey and Argentina) are going through notable difficulties.

In any event, as they deal with the low profitability of their domestic business, Spanish banks will have to guard against overly relaxing their loan approval and selection criteria.

The third challenge facing the banking sector is that associated with the process of adapting to a more stringent regulatory framework with higher own funds and liquid assets requirements and other additional requirements derived from the new resolution regulations. Spanish banks have already largely adapted to the new requirements, and their liquidity and solvency ratios stand above the minimum requirements, although as can be seen in Chart 19 their CET1 capital ratios are low compared with those of the other euro area banking systems, underscoring the need for banks to strengthen their capital levels. It should be noted that although most of the regulatory changes have already taken place, some reforms have yet to be applied in full, such as the Basel III review and the MREL requirements, which will involve further adaptation by banks.

Lastly, the main future challenge facing Spanish credit institutions relates to the new competition framework stemming from the emergence of new technologies and growing financial disintermediation. In particular, although high uncertainty surrounds this area, new technologies clearly pose the most significant challenge (and opportunity) for banks in the medium and long term. These technologies may rapidly alter the competition framework, increasing competition in some segments and changing both the demand for banking services and the way in which they are provided. This means that banks will have to respond by anticipating and adjusting to the new environment, even though this may entail higher costs in the short term.

The current degree of penetration of new technologies is comparatively low in Spain, as shown in Chart 20. This, together with Spain's extensive bank branch network, leads one to believe that there is considerable room for growth in digital banking and for efficiency gains, providing a growth opportunity for Spanish banking institutions.

Growing financial disintermediation is yet another challenge for the banking sector. Its intensity will depend on short-term and structural factors relating to monetary policy developments, the emergence of new competitors, progress in the capital markets union and long-term saving trends.

Challenges facing the euro area

Lastly, let me now turn to the challenges facing the euro area, since the outlook for the Spanish economy also relies to a crucial extent on these challenges being adequately met.

In this respect, despite the improvements made in the European architecture in recent years, more progress is needed to enhance euro area stability, requiring further steps to reduce risks and also to share them between the Member States.

It should be recalled that, after several years in which limited progress was made in euro area institutional reforms, it is now more than a year since the European Commission took the initiative to re-open the debate, with the reflection paper on the deepening of the economic and monetary union.

This debate revealed a variety of views on the role to be played by national responsibility and solidarity between Member States in the institutional framework of the euro area in order to achieve greater stability and prosperity. At the summit of heads of state and government of the euro area countries in June 2018, a number of agreements were reached for progress in institutional reform and to address several urgent challenges. Thus, the European Stability Mechanism (ESM) will act as the common financial backstop for the Single Resolution Fund (SRF) and its role in the design and supervision of assistance programmes will be strengthened, with a possible review of the instruments at its disposal. During the last stretch of the year, the Eurogroup is to work on these two initiatives, with a view to their being adopted at the December summit.

The Eurogroup should also continue to discuss other possible elements for completion of Economic and Monetary Union. In particular, definition of a roadmap for the creation of a

European Deposit Insurance Scheme (EDIS) with sufficient shared fiscal backing would be desirable. In the economic and tax spheres, some kind of common cyclical insurance mechanism is also needed, to cut adjustment costs for countries experiencing asymmetric shocks, and help is needed to design a fiscal policy more tailored to the euro area as a whole so that, in the event of a severe crisis, monetary policy will no longer be the only tool available to uphold aggregate demand.

In future, further progress must also be made in the capital markets union, which is essential to achieve greater capital market integration, fortify banking union and strengthen the private mechanisms for efficient allocation of financial resources and the risks associated with their investment throughout the European Union.

Conclusions

As you can see, the Banco de España's *Annual Report* provides an ambitious analysis and diagnosis of the Spanish economy.

The main conclusions drawn in the Report, which was prepared in the first half of the year, remain essentially valid, despite the apparent growing deceleration of the global, European and Spanish economies:

- First, the need to take advantage of a level of economic growth that is still above potential to speedily and determinedly address the necessary fiscal consolidation process. In this respect, guaranteeing the financial sustainability of the public pension system is particularly important, in view of the medium-term implications. For this purpose, a comprehensive package of measures to address the effects of population ageing on the economy is essential.

- Second, advantage should also be taken of the current cyclical conditions to intensify the structural reform agenda and prevent its reversal. In the case of the labour market, the level of temporary employment and repeated contract renewals should be reduced, without undermining job creation, active policies should be focused on the most effective measures to enhance employability and set in place mechanisms that facilitate greater alignment between wage conditions at individual firms and their productivity levels. These factor market reforms must be accompanied by product market reforms that encourage business competence and competition. Productivity gains in the economy also demand improvements in human and technological capital.

- Third, in the financial sphere, the Spanish financial system continues to face various significant challenges. Notably: (i) the need for banks to continue to actively manage their impaired assets, so that the financial system, through its lending activity, may continue to support economic growth; (ii) the need to recover profitability levels, without unduly easing credit standards; (iii) the need for credit institutions to strengthen their capitalisation levels, to adapt to a more demanding regulatory framework; and (iv) the need to address the competitive challenge stemming from the emergence of new technologies, competitors and services in the financial sphere.

The materialisation of some of the risks to the economy that were discerned six months ago only adds to the importance of the challenges for the medium and long term highlighted in the Report and, as I have tried to stress today, to the need to address these challenges speedily and with sufficient resolve.