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Economic policy: the challenge of future crises

Speech by the Governor of the Banco de España at the Barcelona Círculo de Economía to mark ten years since the Lehman Brothers collapse

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I wish to start by thanking the Barcelona Círculo de Economía for their kind invitation to be here with you today, to close this cycle of lectures organised to mark the tenth anniversary of the collapse of Lehman Brothers. The economic and financial crisis was attributable to a broad and complex range of factors, but there is no doubt that this event remains engraved on the collective memory as a moment of particular significance, marking in a way the symbolic start of the crisis.

The past decade has provided us with numerous lessons for the future, in particular in the area of economic policy management. Today, in order to identify outstanding tasks, I am going to devote my speech to a review of the changes that have occurred during these years, both at international and national level, which determine our ability to prevent the emergence of new crises or to mitigate their effects should they materialise.

I shall start with the reforms at international level, in particular in the global financial architecture, and the risks arising from protectionism, the intensification of which may have significant negative effects on world growth in the medium term. I will then address the changes in euro governance, before moving on to discuss the role played in recent years by monetary policy. Finally, I will focus on the case of Spain, to briefly review the events of the last few years and then outline the main challenges facing the public finances, supply-side policies and the banking industry.

Progress on institutional design and supra-national economic policies and their challenges

Reform of the international financial system

At international level, the global financial crisis highlighted the need for far-reaching reform of the regulatory and supervisory frameworks. The efforts made in recent years in this area have given economic policymakers updated instruments and new tools with which to address future risks relating to the financial system, its stability and its relationship with the economy as a whole. Thus, right from the early stages of the crisis, the G20 set in motion a series of reforms covering a number of areas, including microprudential and macroprudential banking regulation, international accounting standards and the regulation and monitoring of non-banking sectors, among other measures. We are currently in the phase of assessing the suitability of all these new instruments, some of which are still to be tested in crisis situations.

In the microprudential domain, the Basel Committee on Banking Supervision undertook a far-reaching review of the regulatory framework, which would become known as "Basel III", with the aim of increasing the resilience of the banking system and reducing the impact of financial crises on the economy. Some of the key reforms introduced include an increase in the quantity and quality of minimum regulatory capital and the creation of capital buffers. New prudential requirements have also been introduced, such as the limits on large exposures, a maximum leverage ratio and two liquidity requirements, at the same time as the reform of the frameworks for evaluating market risk and securitisations has been launched.

In addition, last December, a second wave of reforms introduced within the framework of the Basel Accords was completed. The focus of these measures has been the calculation of risk-weighted assets, i.e. the denominator of the capital ratio, in order to improve the comparability of capital ratios across banks and jurisdictions.

Another lesson of the crisis was that it is necessary to prevent and mitigate the effects of an excessive build-up of risk in the financial system as a whole. An exclusively microprudential based regulatory framework is clearly not sufficient to achieve this. New instruments were considered necessary to help moderate and address cyclical systemic risks (such as, for example, those associated with the credit cycle) and cross-sectional systemic risks (for example, those linked to the risk arising from, among other aspects, the size, complexity and density of the interconnections between financial institutions).

With regard to cyclical systemic risks, a countercyclical capital buffer has been introduced, with a view to preventing risks arising from excessive credit growth at the aggregate level. As for cross-sectional systemic risks, the Financial Stability Board promoted a set of measures to strengthen the capital requirements for systemic banks and to establish stricter supervisory requirements and stronger resolution frameworks for them.

The development of microprudential policy also entailed changes of an institutional nature. In Europe, the European Systemic Risk Board was created, with the task of microprudential supervision of the financial system of the European Union (EU). However, at the same time it was necessary to create a framework for action at national level to enable the different sources of systemic risk to be monitored and the adequacy of the new macroprudential policy matters and instruments available to be assessed.

Following this roadmap, the Spanish Government has recently announced its intention to create a macroprudential authority comprising representatives of the Ministry of the Economy and Enterprise, the Banco de España and the National Securities Market Commission. This new authority will be responsible for the macroprudential supervision of the Spanish financial system, with the aim of contributing to the prevention and mitigation of systemic risk.

The crisis also highlighted certain vulnerabilities in the international accounting standards, resulting in the provisions needed to cover risks being recognised late and being inadequate in amount. In response, an expected loss accounting model was introduced, which, along with the reforms in the prudential area, helped improve recognition of credit risk and increasing the resilience of banks to unexpected deterioration in their credit portfolios.

However, the reforms were not only intended to bolster resilience and alerts in the face of shocks and sources of risk, but also to promote the development of effective resolution mechanisms. This sought to address the problem known as “too big to fail”, a problem that became obvious during the crisis, when the authorities of various countries were forced to use public funds to rescue banks, owing to the serious consequences that their insolvency might have had on the rest of the financial system and on the economy as a whole.

With regard to resolution, a number of principles have been developed in order to guarantee the orderly management of banks in severe difficulties. These include the development of a bail-in tool to permit an orderly resolution process that minimises the impact on financial stability, ensures the continuity of critical bank functions and minimises the need for public funds.

Apart from the reforms I have mentioned, the G20 promoted stricter regulation and closer monitoring of the activity of non-bank financial intermediaries. The aim was to improve the monitoring of developments in this sector, and to assess which regulatory instruments should be used, taking into account the risks these intermediaries pose to financial stability. These risks may, in certain circumstances, have similar consequences to those traditionally assumed banks.

The measures I have mentioned have generally led to a healthier, more resilient and diversified financial system, without adverse effects on the provision of credit to the economy. In particular, since 2011, the large international banks have almost doubled their highest quality capital, from $2 trillion to $3.7 trillion in 2017. Moreover, since the start of the crisis, they have halved their leverage and improved their liquidity profiles, mainly thanks to an increase in high-quality liquid assets.

Progress has also been made in other areas, such as simplifying and boosting transparency in the OTC derivative markets, including through the use of central clearinghouses, and measures have been taken to reduce some of the risks arising from non-bank financial intermediation.

Nonetheless, we cannot ignore the persistence of certain risks and vulnerabilities. First, although large banks are now less leveraged, overall debt levels remain very high. Global public-sector and non-financial private-sector debt has increased by some 40 percentage points (pp) since the financial crisis to reach 250% of global gross domestic product (GDP); public-sector debt has increased significantly in the advanced economies and private-sector debt in the emerging economies, especially in China.

Second, there has been an increase in the weight of non-bank financing. The weight of other financial intermediaries (OFIs)[1] in the global financial system has been growing in recent years, and reached 30% in December 2016, according to the latest data available. This trend is confirmed by the growth in non-bank financial intermediation, which generates similar risks to banking; its weight in the global financial industry increased from 11.6% in 2010 to 13.4% in 2016. These trends may have potentially important implications for the functioning and resilience of financial markets, in particular at times of stress.

Third, a number of challenges remain relating to implementation of some of the approved reforms, in particular the latest package of Basel III reforms agreed in December 2017.

Finally, now is the time to assess whether the approved reforms are effective and to identify any unintended consequences. In this respect, the FSB is due to launch an assessment of the policies agreed to address the too-big-to-fail problem next year.

Reviewing globalisation and world trade rules

[1] The FSB defines OFIs by exclusion. This is not a statistical definition, therefore, since it covers various categories of the national financial accounts: all non-bank intermediaries other than the central bank, public institutions, insurance entities, pension funds and financial auxiliaries.

The political and social consequences of the crisis have had an impact on economic policy in the area of trade policy, at global level. Trade tensions and the proliferation of protectionist measures are one of the worst legacies of the economic policy response of some countries in the current post-crisis period. In fact, protectionism is currently a significant risk factor for world trade, and given the latest developments, we cannot rule out further escalation of such tensions, with severe consequences for global growth.

There is a broad consensus in the academic literature on the economic costs of protectionism. In the short and medium term, economies subject to protectionist measures suffer reductions in exports and investment, with resulting adverse effects on their activity.

Also, the effects on economies that adopt protectionist measures are far from positive, owing to the increase in the price of their imports, which, in turn, leads to an increase in production costs for their businesses and lower purchasing power for households, which leads to adverse effects on private consumption and investment. In addition, the uncertainty associated with trade tensions and the possible tightening of financial conditions may discourage investment further and worsen the negative impact on activity and potential growth.

The estimates of the main international organisations in relation to the recent trade tensions between the United States and China suggest that the measures currently in force will have a relatively moderate impact (less than 0.5 pp of GDP in China and the United States, with an even smaller effect on global GDP). However, the application of tariffs and additional non-tariff measures, such as those announced by these two major powers, along with the foreseeable deterioration in confidence and in the financial markets to which this scenario could give rise, would involve much higher costs. According to the International Monetary Fund (IMF), it could, over three years, subtract nearly one percentage point from world GDP, with a more pronounced impact on China (-1.5 pp) and on the United States (-1 pp) than on other areas, such as the euro area, where the losses would be somewhat less than 0.5 pp.

Another particularly relevant case at the present juncture is Brexit, which may have very significant effects on the UK and EU economies. Depending on the future framework for relations between the EU and the United Kingdom, and whether or not the departure from the EU takes place in an orderly manner, the latest estimates, published by the Bank of England just a few days ago, range from long-term GDP losses for the United Kingdom of around 2% of GDP in the case of an orderly exit and favourable future agreement, to declines of around 10% of GDP if there is no agreement and the exit is disruptive and disorderly. The costs for the EU would be lower, although in the event of a hard Brexit the impact could be significant for those countries with closer trade and financial ties with the United Kingdom, such as Ireland, Belgium and the Netherlands.

At the same time, the evidence suggests that greater protectionism raises the vulnerability of economies to domestic adverse shocks. This is because international trade allows producers to diversify their business and cope with cyclical fluctuations in domestic demand. This diversification mechanism is even more important in crisis periods, as seen in Spain, where businesses facing severe contractions in domestic demand during the most recessionary phases of the last crisis found an escape valve in the form of exports that enabled them to maintain their activity and limit job losses.

It should also be noted that the negative effects of protectionism tend to grow stronger over the long term, owing to the damaging impact of trade barriers on competition, productivity, technological innovation and potential growth.

In the present context, characterised by the risk of heightened trade tensions, the review of the world trade negotiation rules and reform of the World Trade Organisation (WTO), the legal basis for the main trade exchanges in recent decades, are of even greater consequence. In fact, from a broader perspective, the latest political reactions against free trade come on top of a deeper, pre-existing crisis in the multilateral trade system. The security provided by trade rules enabled average tariffs between the United States, Europe and Japan to be cut from 22% in 1948 to 3% in 2000. However, in the latest round of negotiations between the WTO member countries, which took place in Doha in 2001, very little progress was made and structural problems currently affecting this system became apparent. These include, notably, the requirement for unanimity among the 164 members of the organisation for the approval of new provisions and the existence of a body of rules that has proved to be inadequate to manage the variety of challenges raised by China's joining the WTO in 2001.

A possible way out of the current crisis in the system of rules for world trade and the WTO that has been recently discussed would involve moving from a multilateral system based on unanimity to a more flexible approach. This would allow resolutions to be adopted in particular areas by a limited number of countries, with the possibility of other economies joining them at a later stage.

This multilateral approach could also be used to approve reforms to adapt the WTO rules to the recent changes in the world economy and thus restore global confidence in a system of trade based on respect for clear well-defined rules, curbing the proliferation of protectionist measures and boosting global growth in the long term.

The need to promote the opening up of trade in services, where the potential gains are still substantial, should also be mentioned. Lastly, in the domestic policy realm, the authorities need to adopt a number of policies (boosting labour market flexibility, solid social security networks and education and training opportunities) to satisfactorily address the distribution of the potential benefits of trade among different population groups.

The new institutional architecture for the euro

One of the structural elements that has changed most as a result of the combined financial-sovereign crisis in Europe is the institutional architecture of the euro area. The financial crisis revealed a number of shortcomings and deficiencies in various aspects of the design of the Economic and Monetary Union (EMU), such as the absence of fiscal stabilisation mechanisms for the area as a whole, the lack of crisis management instruments and the incoherence of the supervisory arrangements and of national bank resolution, while there was a manifest need for progress towards genuine financial integration as a logical consequence of the monetary union. We should recall here the weakness of the euro area's cross-country risk-sharing mechanisms based on the capital markets and banking system, especially in comparison with other currency areas of a similar size, such as the United States.

Especially since the emergence of the sovereign debt crisis, in the first part of the current decade, these shortcomings have prompted significant progress in reform of the European institutional architecture, including the strengthening of the mechanisms for surveillance of the fiscal and macroeconomic imbalances and the creation of the European Stability Mechanism, the Single Supervisory Mechanism and the Single Resolution Mechanism.

Despite these reforms, significant limitations persist that require further EMU deepening. First, the second pillar of the banking union needs to be completed by means of the creation of a common backstop for the Single Resolution Fund to guarantee its financial sufficiency. Moreover, it is essential to launch a European deposit insurance scheme to ensure the same level of protection for all depositors throughout the euro area, reducing the risk of bank runs in situations of financial stress and to weaken the “doom loop” between sovereign risk and bank risk.

In relation to resolution, in line with international initiatives, the European resolution directive stipulates a minimum requirement for own funds and eligible liabilities in the event of resolution. The application of this directive poses a number of challenges, in particular in terms of the transition towards compliance with these new requirements by banks, which I shall refer to later when discussing Spanish banks. Also, as the IMF has recently indicated, it would be desirable to assess the suitability of bail-in strategies in the event of systemic crises, given their potentially adverse effects on the financial system as a whole, which may ultimately raise social losses and the cost to the taxpayer.

In order to make further progress in reducing the risk of financial fragmentation within the euro area, it is necessary to boost private-sector risk-sharing channels, such as the credit and capital market channels, so that they work alongside the public-sector risk-sharing mechanisms. This requires, first, removing obstacles to the creation in the medium term of genuine pan-European retail banks. In particular, a single deposit insurance fund needs to be created, the euro area needs to be treated as a single jurisdiction for regulatory purposes and, above all, market pressure needs to reach broad segments of the European banking system, such as public-sector banks, cooperative banks and savings banks.

Second, progress needs to be made on the various Capital Markets Union initiatives. The implementation of this project should lead to more efficient and integrated capital markets, enabling European businesses to diversify and broaden their sources of funding and to reduce their excessive dependence on bank finance. However, this is a complex objective that requires action on various fronts, including the development of market infrastructures, the review and harmonisation of market regulation and supervision and of insolvency procedures, and the elimination of the bias in favour of debt financing in some countries’ tax systems.

It is also necessary to move towards a fiscal governance framework that allows the stabilising capacity of fiscal policy in the euro area in times of crisis to be increased. For this purpose, countries should take advantage of the current upswing to generate scope for stabilisation in future crises, since national fiscal policy will continue to be the first line of defence.

In fact, a fiscal union, with shared responsibility for macro-financial risks that are already subject to common supervision, besides improving incentives would be conducive to the sustainability of public finances and macroeconomic stability in the area.

However, clear, strict fiscal rules are also necessary for the Member States. Simplification of the complex web of rules and procedures that currently make up the Stability and Growth Pact, more automatic rules and stronger independent fiscal institutions, as well as a stronger European Fiscal Board, could also help achieve this objective. Also, the development of a common fiscal capacity that enables an aggregate fiscal stance to be defined and applied in the area would supplement the scope for national fiscal action and, as I have already mentioned, the stabilising efforts of monetary policy.

Completion of the current design of EMU and providing it with solid governance are priorities that will, however, require broad consensus and political will.

Monetary policy

I would now like to discuss the role monetary policy has played in these years and that which it could play in the response to future crises.

When the last crisis broke out, central banks slashed interest rates, which rapidly reached near-zero levels In some cases, such as that of the European Central Bank (ECB), rates even turned negative. In this context, central banks had to implement a series of novel, or "unconventional", measures. These measures included asset purchase programmes, medium- and long-term lending to the banking industry under advantageous conditions, and announcements about the future course of monetary policy, known as forward guidance.

The empirical evidence shows all these measures to have been effective at cushioning the impacts of the economic crisis and supporting the subsequent recovery, and they now form part of central banks' toolkit for the future. Against this background, what scope is there for monetary policy action in the event of a future crisis?

As the inflation outlook improves in the future, interest rates may be expected to rise gradually towards their long-term equilibrium rate. The distance between this level and the effective lower bound on interest rates – i.e. the level below which further rate cuts would be counter-productive as a means of stimulating the economy – will determine the future scope for conventional monetary policy. We now know that the lower bound on interest rates in the euro area is not zero, as was traditionally believed, but a negative number which, although difficult to quantify, is probably not far below the current deposit facility rate of -0.40%.

Economic theory and the empirical evidence suggests that demography is one of the factors underlying the long-term interest rate. Specifically, demographic developments in recent decades in comparable countries, characterised by declining birth rates, increasing life expectancy, and a rising ratio of pensioners to workers, seems to have lowered the long-term equilibrium or "natural" interest rate and is likely to continue to do so in the future. Demographic patterns seem therefore to be contributing to a progressive narrowing of the scope for central banks to lower their interest rates in the event of deflationary shocks like those suffered during much of the recent crisis.

One tool which can mitigate this foreseeable loss of scope for interest rate policy forward guidance. In recent years, once short-term rates reached their lower limit, central bank announcements undertaking to keep interest rates at low levels for long periods proved effective at flattening the yield curve and reducing the uncertainty over possible future interest rate developments, thus improving financial conditions for the real economy.

Other tools that also provide stimulus when interest rates are no longer able to do so include the monetary authority's balance-sheet expansion measures. In recent years, the world's main central banks, including the ECB, have resorted to them with remarkable intensity. In particular, in the Eurosystem the expansion of the balance sheet has mainly been driven by longer-term refinancing operations and the asset purchase programme. These measures have been effective at easing financial conditions in the euro area and, ultimately, at adjusting inflation towards its target. The ECB's asset reinvestment policy, the guiding principles of which were readjusted yesterday, aims to preserve the monetary stimulus provided by the asset purchase programme through full reinvestment of the assets on the programme's portfolio as they mature.

In short, monetary policy will continue to have tools with which to tackle future economic and financial crises, although these tools naturally have their limitations. Therefore, as the Governing Council of the ECB has been saying in recent years, rather than overemphasising the role of these tools, they need to be complemented by the implementation of structural reforms and fiscal policies to foster growth.

Spanish economic policy: progress made and challenges

The Spanish economy has been on a growth path since late 2013 and GDP overtook its pre-crisis levels in mid-2017. A number of structural reforms implemented during the recession contributed to this dynamism. On the domestic front, these include labour market reform, the balance-sheet clean-up and restructuring of credit institutions, pension reform and fiscal consolidation.

These reforms have undoubtedly helped largely correct some of the Spanish economy's main imbalances in the pre-crisis period: in particular, high levels of private sector debt, low competitiveness, the excessive current account imbalance and the excessive weight of the real-estate sector. Similarly, economic policy measures have enabled progress to be made on correcting the problems faced by the financial sector during the worst of the recent crisis.

Nevertheless, the recovery has also benefited from a series of factors exogenous to domestic economic policy with varying degrees of persistence. These factors include the role played by ECB monetary policy and the significant drop in the oil price between mid-2014 and early 2016, and, until the end of last year, the improvement in external markets, in a context of a global economic recovery.

However, the effect of these factors can be expected to taper in the future. The foreseeable loss of momentum by the expansionary effects of demand-side policies is also relevant. In this context, it is particularly desirable for prominence to be given to a renewed reform drive, geared towards correcting the Spanish economy's persisting vulnerabilities.

Fiscal policy

I will first mention the fiscal policy situation. Over the past decade the Spanish authorities have had to make the fiscal adjustment needed to guarantee the sustainability of the public finances. This process has brought the budget-deficit-to-GDP ratio down from a maximum of 11% in 2009 to 3.1% last year.

Despite this deficit cut, Spain's public accounts continue to show significant weaknesses. First, the European Commission estimates the (cyclically adjusted) structural budget deficit to still be around 3% of GDP in 2018, the highest in the euro area. Second, although government debt is on a slightly downward path from its historical peak of 100.4% of GDP in 2014, at around 98%, it is still very high.

The empirical evidence reveals that maintaining a very high level of public debt for a prolonged period tends to hamper economic growth as it becomes a source of vulnerability and reduces the scope for the public budget to act as a stabiliser in the event of a recession.

The simulations made in a number of papers published by the Banco de España show that, on realistic assumptions, the process of reducing Spain's government debt will be very gradual. It may even take several decades to reach a debt-to-GDP ratio of 60%, which is the reference value in Europe's current fiscal rules.

In the light of these considerations, priority should be given to taking advantage of the current favourable economic context to reduce the vulnerabilities deriving from the public finances and create budgetary room for manoeuvre with which to address future crises. These efforts should be given the form of a medium-term programme spelling out the measures enabling the budgetary objectives to be met, and a prudent macroeconomic and public revenue projections.

This process of reducing the fiscal imbalances also needs to be compatible with an improvement in the quality of the public finances. In this connection, the composition of the programme's revenue and expense adjustment is very relevant to achieving its objectives without hindering economic growth. Combining fiscal consolidation efforts with other structural reforms should also help in this respect.

Reducing the vulnerability of Spain's public finances is even more important when we consider the medium and long-term challenge posed by population ageing. The latest estimates predict a significant increase in public expenditure on pensions, health-care and long-term care stemming from the substantial rise in the dependency ratio. Even on the most optimistic demographic projections, this ratio is set to rise from 25% today to 50% by mid-century.

In the case of the pension system, the 2011 and 2013 reforms included a number of adjustments that made it possible to significantly counteract the effect of the expected long-term increase in the dependency ratio. Nevertheless, the latest legislative developments have eased the implementation of these mechanisms with the postponement in application of the sustainability factor until 2023 and, above all, the return to a system of annual pension increases in line with the consumer price index. According to the Banco de España's calculations, reintroducing this indexing system on a permanent basis would lead to an additional spending increment of more than 3 pp of GDP in 2050. Consequently, guaranteeing the financial sustainability of the public pension system will require additional measures on the revenue or expenditure sides of the system to offset this additional burden.

Pending structural reforms

In the context just described, characterised by the need to pass the baton to demand-side policies to underpin the current expansionary phase and boost growth potential, it would be particularly desirable to give more prominence to measures to correct the Spanish economy's structural vulnerabilities and strengthen its capacity to adapt to future shocks.

The structural reforms undertaken in Spain over the course of recent years have helped make the economy more robust and adaptable to adverse situations. This is particularly desirable in an increasingly changeable and uncertain global environment. One of the key elements providing greater resilience and flexibility is the labour-market reform, which gave businesses more internal flexibility. This flexibility provides additional tools with which to adjust labour costs in the event of a short downturn instead of the traditional mechanism whereby workers – mainly those on temporary contracts – are laid off.

Other reforms have also encouraged better allocation of funds by the financial system to new, higher potential, investment projects. These include financial system reform and insolvency law reform, in particular.

Despite these changes, the Spanish economy still faces major structural challenges that limit its potential growth. I would like to highlight three of these challenges: population ageing, the high unemployment rate, and low productivity growth.

Population ageing has consequences for the effectiveness of traditional macroeconomic policies, the sustainability of the public finances, and productivity growth. Addressing this challenge requires a multidisciplinary policy that creates incentives for older workers to remain in the labour force, revises migration policy to try to adapt it to the needs of the labour market, and boosts the birth rate to bring it closer to rates in other European countries by improving the work-life balance and enhancing job stability in the childbearing years.

Meanwhile, the high unemployment rate remains a serious drag on growth and welfare. Specifically, it is particularly worrying that almost half of the unemployed have been in this situation for over a year and that the unemployment rate among low-skilled population groups stands at over 25%. The serious mismatch between the skills of employees and the unemployed that tends to arise in such cases suggests there is a need for active employment policies to foster the employability of all socio-demographic groups using the tools that have proven to be effective for each of them. A rigorous evaluation of all the existing programmes is therefore necessary.

In addition to considerations of economic efficiency, as highlighted by a recent analysis by the Banco de España, a lower unemployment rate is directly reflected in an improvement in levels of inequality. This positive effect of employment on income inequality would be strengthened by reducing the high level of temporary employment in the labour market, provided this decrease did not come at the price of reducing the incentives for permanent hiring.

As regards productivity, Spain's levels are low by international standards. Improving the dynamics of this variable requires measures in various areas. In particular, it calls for improvements in human and technological capital. In this regard, it is necessary to bolster the legal framework for education to raise quality and address the challenges posed by globalisation, technological progress and automation. This reform also needs to foster innovation in universities and channel it toward the productive system.

Additionally, despite the fact that the more productive companies have gained weight in their respective sectors over the past decade, there are still certain obstacles limiting the efficient allocation of resources. Specifically, there is a need to analyse the level of competition in sectors with persistently high profit margins. It would also be desirable to reduce the impact of factors preventing the most productive companies from growing. In this regard, the regulatory thresholds contingent on company size in the legislation need revising.

Making decisive progress on this structural reform agenda is crucial to increasing the economy's long-term growth and laying the foundations for a society that offers its citizens more opportunities. Many of the policies I referred to earlier foster reductions both in the economy's structural imbalances and in inequality, such that it should be possible to build a broad-based consensus for their approval, despite the obvious difficulties caused by the current political fragmentation.

The challenges for the financial sector

In the wake of the last crisis, Spanish banks carried out a thorough process of balance-sheet clean-up, recapitalisation and restructuring which, over the last four and a half years, has markedly improved the industry's position on basic parameters, such as asset quality or levels of profitability and solvency.

Starting with asset quality, between December 2013 and June 2018 there was a very significant reduction in non-performing loans and foreclosed real-estate assets. Similarly, return on equity returned to positive terrain with rates above the euro area average, recovering from its slump to -25% in 2012. For its part, the total capital ratio has increased by 1.7 pp over the past four years, and the leverage and liquidity ratios are above the European averages. Indeed, recent stress tests by the European Banking Authority and the Banco de España show Spanish banks' solvency position gives them considerable resilience against adverse scenarios.

Nevertheless, even recognising the significant progress made in recent years, the Spanish banking sector continues to face important challenges, which it largely shares with other euro area banking systems. The most significant of these challenges are: i) speeding up the sale of unproductive assets; ii) strengthening capital and liabilities subject to bail-in; iii) improving the industry's reputation by avoiding the risk of misconduct; iv) confronting the challenge of profitability without undue easing of lending standards; and v) making progress in the use of new technologies, which, although they represent a major challenge for the sector, at the same time they present an opportunity for those entities able to use them to their advantage. In short, the supervisory community and financial institutions share the future challenge of ensuring a more stable financial system that offers better services to society.

Concluding remarks

In this talk I have reviewed economic policy's existing room for manoeuvre and instruments with which to address future crises.

I started by discussing those elements (such as reform to the euro's institutional architecture, international financial system reform and developments in world-trade rules, which will increasingly shape national economic policy).

I then turned to monetary and fiscal policy, which are the main tools for managing the economic cycle, arguing that, at present, and for different reasons, they both have less freedom of action than in the recent past.

Therefore, in my opinion, the fundamental conclusion is that it is necessary to take advantage of the current cyclical position in Spain, while conditions remain favourable, to build up budgetary leeway for future recessions and to introduce structural reforms to take over from recent years' expansionary demand-side policies in order to prolong the current economic growth phase and boost the economy's growth potential.

In short, economic policy provides us with a national, European and global toolkit that, if we wish to avoid repeating the errors of the past, we should use properly to prepare ourselves for the next economic crisis, which will surely arrive. The anniversary of the collapse of Lehman Brothers ten years ago, and the economic and financial crisis we have suffered, particularly in Spain, should spur us to press ahead with the reform drive so that, paraphrasing the recent winner of the King Juan Carlos Prize in Economics, Carmen Reinhart, next time is different.