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Monetary policy and bank profitability in an environment of uncertainty

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Ladies and gentlemen, good morning.

I should like to thank the Valencian Economic Research Institute for the invitation to speak at this conference on the Spanish banking sector, which this year marks its tenth anniversary. I am honoured and delighted to participate in this event and share some reflections with you regarding the current profitability of Spanish banks and the main challenges that will shape their future. As you know, this is a subject that is attracting a lot of attention in Europe, both on the part of analysts and supervisors and the industry itself, owing to the concern about banks' low profitability.

Before I address this issue, allow me to start by describing the economic situation in the euro area and, in particular, the decisions taken by the Governing Council of the European Central Bank (ECB) last week. This is very relevant for the financial system, insofar as it is the context in which its activity will be carried out over the next few years.

1. The economic situation in the euro area and the monetary policy response

The international economic context has undoubtedly become more unfavourable over the past year, with a slowdown in growth and, in particular, in trade. The latest information shows that global activity slowed across the board in the second quarter and the highest frequency indicators point to persistence of this weakness over the coming months. Meanwhile, the decline in world trade appears to have steepened, against a background of heightened uncertainty regarding the trade policies of the United States and China and intensification of geopolitical risks. Although the decline in activity has been particularly strong in manufacturing, the slowdown in recent months in the global services output PMI, which remains in expansionary territory, is indicative of an increase in the risk of a greater slowdown in global activity.

Given its degree of openness and the existence of certain idiosyncratic factors, the euro area economy has been one of the most affected by these international trade developments. Specifically, there was a significant slowdown in the euro area from the beginning of 2018, mainly due to the sharp moderation in its exports. As a result, in 2018, GDP grew at an average rate of 1.8%, 0.7 percentage points less than in 2017, while year-on-year growth fell to around 1% in late 2018 and early 2019.

The latest information shows that euro area GDP growth in the second quarter, adversely affected by export weakness and sluggish investment, was only 0.2% quarter-on-quarter, down from 0.4% in the first quarter. By contrast, private consumption continued to grow, driven by the relative strength of the labour market. On the supply side, industrial activity contracted in this period, while services continued to behave more favourably. By country, the decline in activity in the German economy and the stagnation in Italy were notable.

Furthermore, the available indicators suggest that the weakness of economic activity in the euro area persisted in the third quarter of the year. Thus, the indicators relating to trade and industrial activity (industrial production, export orders, manufacturing confidence and industrial production expectations) continued to deteriorate. Also, certain survey indicators of activity and employment in services showed a downturn, which may indicate that the weakness is beginning to spread to these activities. The slowdown in employment, along with the gradual decline in consumer confidence in the third quarter, points to more modest growth in private consumption, which until now has been the main driver of growth.

In this context, the ECB published its macroeconomic projections for the euro area as a whole last week. Projected GDP growth was revised downwards, especially for 2020. Specifically, growth is now projected to be 1.1% in 2019 and 1.2% in 2020, in both cases lower rates than were projected in June. In the medium term, a recovery in activity is expected, underpinned by favourable financial conditions and the slightly expansionary fiscal policy stance, assuming that the political and trade uncertainty gradually dissipates.

Notwithstanding this downward revision to the macroeconomic projections, the ECB's Governing Council stressed that there remain important downside risks to the central scenario, arising mainly from the possibility of a no-deal Brexit and a possible escalation of trade tensions.

Inflation in the euro area remains at low levels. In the third quarter, inflation developments were marked by the downward dynamic of energy prices and the persistence of moderate rates in services and industrial goods. The annual rate of change in the harmonised index of consumer prices (HICP) held steady at 1% in August, for the second month running, while underlying inflation, which excludes energy and food prices, stood at 0.9%. In fact, since 2013, inflation in the euro area has stood on average at 0.9%, practically half the level observed during the first 10 years of EMU, of 2.1%.

In parallel, the indicators of long-term inflation expectations, based on financial market information, have fallen sharply since the end of last year and stand at very low levels, which broadly coincides with the signals obtained from surveys. These indicators are regularly used to monitor the degree to which inflation expectations are anchored to the ECB's medium-term inflation target (below, but close to, 2%). Although most of the reduction in inflation expectations, according to market indicators, seems to stem from the fall in the inflation risk premium, the level of this premium is in negative territory, which would indicate that agents are hedging the risk of very low or even negative inflation rates.

This absence of inflationary pressures and the weakness of demand, along with expectations of falling oil prices and a deteriorating global environment, led to a further downward revision to the Eurosystem inflation projections. Inflation was projected to stand at 1.2% in 2019 and, following a notable downward revision of 0.4 percentage points, 1% in 2020. In 2021, inflation is expected to stand at 1.5%, clearly below the monetary policy target.

These developments have been accompanied by a reduction in long-term yields on sovereign debt markets, which have reached historic lows in most euro area countries and in the United States, as a consequence of the weakness of the macroeconomic environment and market expectations of the central bank response to this scenario of reduced economic momentum.

In short, the macroeconomic context is characterised in the euro area, first, by a downward revision to growth forecasts, which were already relatively weak, which remain subject to downside risks, owing to the persistence of trade tensions and other geopolitical uncertainties, such as those relating to the final outcome of Brexit, and which in some countries of the area even point to a risk of imminent recession; and second, by medium-term inflation projections that have also been revised downwards and are well below the levels that could be considered compatible with the ECB's price stability mandate.

The measures adopted by the Governing Council of the ECB at last week's meeting should be understood against this background. In particular, and in keeping with previous communications, the Governing Council acted – with a package of expansionary measures – in response to inflation rates, both realised and projected for the coming years, which have remained persistently below the ECB's aim, in line with its commitment to symmetry in relation to this aim. In this context, symmetry means that the ECB undertakes to act with the same determination whether inflation is persistently above or below 2%.[1]

In particular, the Governing Council of the ECB took the decision to decrease the interest rate on the deposit facility by 10 basis points to -0.50% and reinforced its forward guidance on interest rates by indicating that they will remain at their present or lower levels until it is seen that the inflation outlook robustly converges to a level sufficiently close to, but below, 2%. Such convergence should also be consistently reflected in the observed behaviour of underlying inflation.

The ECB also agreed to restart net purchases under its asset purchase programme (APP) at a monthly pace of €20 billion as from 1 November and without a defined time limit. In order to preserve favourable bank lending conditions, the modalities of the new series of quarterly targeted longer-term refinancing operations (TLTRO III) were also changed, eliminating the 10 bp spread established on the interest rates applied to them and extending their maturity from two to three years. Finally, in order to support the bank-based transmission of monetary policy, a two-tier system for reserve remuneration was announced, such that part of banks' holdings of excess liquidity will be exempt from the negative deposit facility rate.

These decisions aim to counter the worsening growth and inflation outlook by means of a package of measures that complement one another, easing financial conditions by a different route. Thus, the cut in the interest rate on the deposit facility will have a moderating effect on yields at the short end of the different yield curves, which extends to the interest rate term structure as a whole, thus reducing the cost of borrowing for households and for firms.

This effect is reinforced by the changes introduced in the forward guidance on interest rates, which closely links the potential normalisation of interest rates to a robust convergence of the inflation outlook to a level "sufficiently close to, but below, 2%". Moreover, such convergence should have been reflected, as mentioned earlier, in actual inflation dynamics.

This forward guidance on interest rates and the resumption of net asset purchases seek to have an impact on the medium and longer-dated segments of the yield curve, mainly through interest rate expectations in the case of forward guidance, and term and risk premia in the case of asset purchases. The resumption of net purchases, without a defined time

[1]See the Governor of the Banco de España's closing address of the La Granda Courses on 31 August 2019, "The European economic policy response to a scenario of lower growth and inflation".

limit, also has an important signalling effect with respect to the Governing Council's commitment to meet its inflation aim, which is particularly relevant in the current context of inflation expectations at risk of becoming de-anchored.

In addition, the period of time over which the net asset purchases and the reinvestment of existing assets will continue is anchored to the normalisation of interest rates, thus enhancing the consistency and complementarity of the different measures and their dynamic adjustment to inflation. In a setting of heightened uncertainty, this automatic adjustment of the expectations about the future path of monetary policy in the face of potential changes in the macroeconomic environment is particularly desirable.

Lastly, the improved conditions of the new TLTRO-III programme seek to further ease the conditions of bank lending to the real economy.

Economic research, including that produced by the Banco de España in recent years, shows that these measures have been effective in the recent past, in terms of easing financial conditions and encouraging lending. Bearing this in mind, the new package of measures will boost economic activity in the euro area against a background of high uncertainty and will help to bring about the convergence of inflation to levels in line with the ECB's mandate.

As regards negative interest rates, although there is no conclusive evidence to date that they have adversely affected the supply of bank credit, we cannot rule out that maintaining rates at very low levels for an additional, potentially extended, period of time, could ultimately have some negative consequences for the bank-based transmission of monetary policy. In this regard, the mitigating measures adopted by the ECB, consisting of a tiered system for remunerating excess liquidity holdings, are intended to soften the negative impact on bank profitability of the new reduction in reserve remuneration, and thus ensure the expansionary effect on activity and inflation of any additional cuts to interest rates in the current setting.

2. Banking sector profitability

This is the economic environment that banks, economic agents and, in particular, financial institutions will face in coming years. If I may, I will now move on to analyse the developments in Spanish banking sector profitability and the determinants thereof.

Profitability is one of the main variables that characterise the financial position of banks and it provides the first line of defence against adverse shocks. Indeed, the volume of a bank's profits determines the return its owners can earn on the capital invested. This, duly adjusted for the risks assumed, will affect the bank's valuation. Moreover, profit levels determine the margin these agents have available to address shocks. Indeed, low profitability reduces the possibility of generating capital internally through retained earnings. Note that the capital of banks acts as a buffer that allows potential losses to be absorbed in adverse scenarios, so that these intermediaries can continue to offer financial services to households and firms, thus contributing to smoothing – rather than amplifying – negative shocks to the economy.

Also, a high level of capital entails a stronger link between the personal wealth of the owners and the economic performance of the banks, thus contributing to mitigate the risk profile that the latter are prepared to assume and, therefore, the likelihood that they will overreach themselves and will subsequently require traumatic correction measures. All of this explains the concern of banking regulators that banks should hold sufficient capital.

The last financial crisis showed that banks' capital levels were clearly insufficient to address the economic and financial shocks that arose. In response to the crisis, international financial regulators tightened capital requirements, setting higher minimum levels and requiring capital of higher quality, as well as introducing requirements for minimum liquidity levels.

As a result, the main international banking systems have gradually raised their solvency ratios in recent years. The Spanish banking system has gradually adapted to the new regulations and its capital ratios are currently in excess of regulatory requirements. However, in the case of ratios calculated in terms of risk-weighted assets, such as the CET1 ratio, average levels are comparatively low and have risen by less than in the main European banking systems. By contrast, in terms of the leverage ratio, that is, when banks' assets are not risk-weighted, the relative position of the Spanish banking system is more favourable, standing somewhat above the European average and above that of the main European banking systems.

Spanish bank profitability since the start of the crisis

The profitability of the Spanish banking system contracted sharply during the last economic crisis and more severely than in other jurisdictions: in 2012 return on equity reached a negative level of -21% and return on assets a negative level of -1.2%, according to the consolidated statement information which reflect not only business in Spain but also international exposures. The main determinant of this performance was the increase in loan losses associated with the significant increase in non-performing loans, in particular in construction and the real estate sector to which banks were over-exposed.

Despite the drop in aggregate profit levels in the first half of this year, in recent years the profitability of the Spanish banking system has tended to recover, essentially underpinned by the decline in impairment losses which reflects the improvement in the quality of the credit portfolio. The reduction in non-productive assets – non-performing loans and foreclosed assets – has played a fundamental part. Specifically, the ratio of non-performing loans to the resident private sector in Spain has fallen from 14% in December 2013 to 5.3% in June 2019, and the volume of foreclosed assets has decreased from almost €78 billion in December 2013 to €40 billion in June 2019. This has been achieved by sales of large non-performing and foreclosed asset portfolios, partly as a consequence of regulatory and supervisory pressure.

These latest developments have occurred in a favourable macro-financial setting characterised by growing economic activity, falling unemployment and lower interest rates. This has boosted borrowers' ability to repay their loans, driven up asset values and has also been compatible with substantial deleveraging in the non-financial private sector and with a major consolidation process in the banking sector.

Spanish banking system earnings are highly cyclical, essentially on account of business in Spain. Banks that are more exposed to business abroad were comparatively less hard hit by the crisis, as they were able to offset the losses on their Spanish business with earnings from their activities in other economies that were less adversely affected by cyclical patterns. Naturally, these international exposures also entail other risks. For example, banks with exposure to the United Kingdom could be affected by the possible negative impact of Brexit and the effects it may have on the UK economy. In addition, the problems facing certain emerging market economies, such as Turkey or Argentina, may affect banks that have exposure to those countries. However, despite these risks, international diversification of the banking business offers important advantages overall and especially, as was apparent in the last crisis, when it is focused on retail banking and is organised on a decentralised basis.

Despite the recent recovery observed in Spanish banking system profitability, the present levels are below the pre-crisis levels and below the cost of capital estimates available. This situation is not exclusive to Spain, but is in fact quite widespread within the euro area. Indeed, the average profitability of Spanish banks is currently somewhat higher than that of the main European banking systems and the euro area average.

The breakdown of the return on assets shows that the main reason why Spanish banks' profit levels are higher than the euro area average is that their net interest income is higher. This reflects the larger relative share of Spanish banking business in less mature markets, such as the Latin American economies, where margins are higher. Conversely, Spanish banks have higher impairment related expenses and provisions than their euro area peers.

Average return on equity among Spanish banks is also higher than for banks of other European countries such as Switzerland or the United Kingdom or for Japanese banks. But it is lower than average return on equity observed in other more profitable banking systems, such as the United States, Sweden, Norway, Canada and Australia.

In any event, there is a high level of dispersion in profitability between banks, both in Spain and in the rest of Europe. This shows that profitability problems do not affect the sector evenly, given the range of banking business models, both between countries and within each jurisdiction, and also the combination of multiple explanatory factors.

To facilitate a better understanding of the factors underpinning the Spanish banking system's low profitability levels compared with the pre-crisis levels, I will now concentrate on business in Spain. This is because changes in profitability in the consolidated statements are influenced by the growing share of international exposure observed in recent years and this makes it more difficult to interpret earnings as they are affected by significant changes in composition. Also, there are only a small number of banks that have significant international exposure, which means that changes drawing on consolidated statements may not be very representative of the majority of the banking sector.

The profitability data drawing on individual statements of business in Spain are also highly cyclical, even more so than those drawing on consolidated statements. This reflects the greater severity of the crisis in Spain compared with the situation in other economies to which Spanish banks held exposures. There are also signs of a marked recovery in recent years, despite which, in 2018 both ROE and ROA were still below their pre-crisis levels.

The breakdown of the return on assets shows that the main determinant of the current low level of profitability of business in Spain compared with the pre-crisis period is a narrowing of net interest income in terms of assets, or net interest margin. This narrowing was concentrated in the period 2009 to 2013, when the margin fell from 1.4% to 0.9%; since then this indicator has steadied at around 1% of total assets.

There are several factors that may explain the decline in net interest margin observed in this period. First, it is the result of the increase in the relative share of non-productive assets, that is, assets that do not earn interest, such as non-performing loans or foreclosed assets.

In addition, this period saw a severe contraction in banks' credit portfolios, a reflection of the sharp correction in the high indebtedness accumulated by Spanish households and firms in the pre-crisis years, and of the loss of share of the banking system in the financing of the economy. Banks cushioned the balance sheet effect of this contraction in their credit portfolios by increasing their exposure to other assets, especially through government debt purchases. As these debt securities provide lower returns than lending to households and firms, in the long run this portfolio rebalancing resulted in a fall in the average return on assets. However, when the sovereign debt crisis came to an end, the increase in value of these debt securities provided a positive, albeit short-lived, boost to profitability.

On our estimates, the overall effect of these changes in asset composition – associated with the increase in non-performing loans and the decrease in the relative share of credit on balance sheets – would explain some 70% of the decline in net interest margin in the Spanish banking system between 2007 and 2018.

The fall in market interest rates has also played its part in narrowing the net interest margin, since the cost of liabilities, and especially of deposits, which are the main source of funding for Spanish banks, tend to be less sensitive to changes in market returns than the remuneration of assets. This effect heightens when interest rates move close to cero, since this level has served as a lower bound for the cost of deposits. The reason for this downward stickiness in the cost of deposits is that negative interest rates in these instruments could reduce the supply of funds, especially in the case of households, as they would prefer to hold cash, which has zero but not negative remuneration, rather than deposits.

An analysis of the average loan-deposit gap in the case of outstanding balances shows that there is in effect a historically positive relationship between this variable and the level of market interest rates. Nevertheless, the fact that since 12-month EURIBOR turned negative in February 2016 the loan-deposit gap has not narrowed and in fact has widened is quite striking. There are two reasons for this. The first is that average remuneration of loans has been sustained in recent years by the decline in non-performing loans, which has reduced the proportion of loans not earning interest. The second reason is that in February 2016 there was still some margin for decline in the cost of deposits, which averaged 0.35% for outstanding balances and 0.20% for new business. As a result, since that date deposit rates on new business have fallen by a similar amount as average remuneration of loans. Now, however, as the cost of deposits has come very close to zero, it would be more difficult to pass any further decreases in remuneration of assets through to the cost of deposits.

It is often argued that banks' net interest income is being adversely affected not only by the low level of interest rates but also by the flattening of the yield curve observed in recent years. This effect depends, first, on the extent to which there are positive differences between the maturity of the assets and the liabilities of banks. In general, these financial intermediaries receive short-term funding and provide long-term financing; this is known as maturity transformation. However, in order for the flattening of the yield curve to have a negative impact on net interest income, in addition to there being maturity transformation, banks need to be granting fixed-rate loans. If they are lending at variable interest rates, the remuneration will usually be linked to short-term yields, thus contributing to holding the loan-deposit gap steady.

In the case of Spain, although banks operate with maturity transformation, the bulk of their long-term lending is variable rate. In consequence, the flattening of the yield curve in recent years should have had less impact on Spanish banks' net interest income than on the net interest income of banks in other European jurisdictions such as Germany or France where fixed-rate loans predominate.

In any event, in order to assess the overall effect of interest rates on the profitability of banks, it is necessary to take into account that interest rates not only impact the net interest margin but they also impact other items in the income statement.

In particular, lower interest rate levels help to lessen losses in the credit portfolio due to their favourable effect on borrowers' repayment capacity associated with both the lower cost of credit, and higher income and lower unemployment tied to the macroeconomic impact of lower interest rates. These effects may be particularly important in countries like Spain where the banking system started out with a high level of non-performing loans and where short-term or variable rate lending was prevalent, since this results in movements in market returns passing through rapidly to the costs of outstanding debt[2]. Thus, part of the fall in the non-performing loans ratio in recent years can be explained by this effect.

Furthermore, declines in interest rates contribute to increasing the prices of financial and real assets. This effect is immediate for fixed-income securities, particularly long-term ones since prices are more sensitive to changes in yields. Valuations of equities and real assets, such as housing, are also boosted by the fall in interest rates due to the effect on the discount factor, although the price of these other assets is influenced by other conditioning factors such as macroeconomic expectations. All the above entails capital gains for banks exposed to these financial and real assets, at the same time as it increases the value of loan collateral. This also favours an improvement in the credit quality of loans and, therefore, smaller losses in the credit portfolio.

It is true, in any event, that these capital gains dry up once interest rates stop falling and remain at low levels. Furthermore, there is also evidence that, since the ECB's deposit

[2] See, Banco de España (2018): Annual Report 2017, Chapter 2, "The challenges facing the Spanish banking sector" and Banco de España (2017): Annual Report 2016, Chapter 1, Overview, Box 1.3.

facility rate has stood below zero, negative surprises in short-term interest rates have been accompanied by declines in European banks' stock prices.[3]

Given the endogenous nature of the monetary policy response to projected economic developments, this change in banks' stock prices due to monetary surprises may reflect, on one hand, the negative impact of less favourable projections for the future macroeconomic setting and, on the other, the market view on the direct negative effect of additional interest rate cuts on the future profitability of banks against the backdrop of protracted negative rates.[4]

In recent years, Spanish banks have partially cushioned the fall in net interest income by generating other income and, in particular, by increasing fee and commission income. Noteworthy among these fees is the relative increase in fees for selling products such as investment funds, against a backdrop of growing demand for these assets, bolstered by households seeking more profitable investments than deposits given their low returns. These developments have resulted in the ratio of gross income to assets, which includes fees in addition to net interest income, having fallen to a lesser extent than the net interest margin.

Banks have also made huge efforts to reduce their operating expenses through branch closures and job cuts, but to date these expenses have declined more moderately than gross income. This was reflected in a continued increase in the ratio between these two magnitudes, that is, the efficiency ratio, until 2017, which underlines the deterioration in their efficiency during this period. This trend seemed to come to a halt in 2018 when this ratio improved slightly. In terms of assets, in 2018 operating expenses were at similar levels to their pre-crisis ones. However, in a setting where the share of credit in assets is currently significantly lower than it was then, these expenses should also be smaller given that the costs associated with the management of non-credit assets are lower.

The information in the consolidated statements also shows that the most recent levels of the efficiency ratio are above pre-crisis ones, therefore indicating a situation of lower efficiency. However, despite this deterioration, the ratios of the Spanish banking system in this area continue to be more favourable than those of the main European banking systems and also than those of banks in the United States and Japan, although they are worse than those of the Scandinavian countries.

Main challenges affecting the future profitability of Spanish banks

Next, I shall briefly mention the main challenges facing Spanish banks which affect their future profitability outlook. These challenges are not confined to the Spanish banking system but are largely shared with other jurisdictions.

One of the major challenges which banks must face is linked to technological change. New technologies represent both threats and opportunities for banks. On one hand, they promote the emergence of new competitors, such as fintechs and big techs. The latter pose

[3] See Ampudia and Van den Heuvel (2018).
[4] Recent literature on monetary surprises distinguishes between purely monetary surprises and other surprises which disclose private information about the future state of the economy. See, for example, Jaroncinski and Karadi (2018).

a more obvious disruption, given their larger size and advantages in terms of the availability of information, a key asset in the digital and financial worlds. Some of these companies have already begun to offer specific financial services which were traditionally provided by banks or have announced that they intend to do so shortly.

Yet on the other hand, adopting technological innovation may also mean efficiency improvements for banks, although it is true that in the short term adapting to the new way of providing financial services and managing their assets will entail hefty costs for established banks.

For society as a whole, the use of new technologies in finance may mean significant advantages in terms of cost savings and financial inclusion. As regulators, we have to promote the adoption of innovation while continuing to treat all participants symmetrically so that regulations governing the same activities are comparable, irrespective of the type of company providing the services.

As I mentioned earlier, the decrease in non-productive assets has been one of the main factors which has contributed to the return to profitability of the Spanish banking system in recent years. Nevertheless, although it has decreased significantly, the share of these assets in banks' balance sheets continues to be historically high and, consequently, banks should take advantage of this point in the cycle to make further progress in this area.

Another important challenge for Spanish banks relates to the need for them to achieve reputational improvements. After the economic crisis, litigation increased notably, resulting in sizeable costs for banks which have a negative effect on their profitability. This increase in legal costs is not confined to the Spanish banking system but has also been observed in other jurisdictions. In addition to having an impact on profitability through higher legal costs, this situation has been accompanied by a reputational deterioration which, if not reversed, may lead to a loss of business in the medium term. This is particularly significant in a setting such as the present one with the emergence of new competitors described above. Consequently, it is essential for the sector to recover customers' trust as soon as possible, this being a key asset in the financial business.

Also, Spanish banks have to complete their adaptation to the new international regulatory and supervisory framework. As indicated, although their capital ratios are above the minimum requirements in the area of solvency, the Spanish banking system still remains below other European countries in the case of the highest quality ratio (CET1). Strengthening capital would not only lead to greater resilience to adverse shocks but it would also bring down issuance costs.[5] In addition, higher solvency would help facilitate compliance with MREL requirements (Minimum Requirement for own Funds and Eligible Liabilities) that Spanish banks will have to gradually meet over the coming years. It will be a considerable challenge for smaller banks to comply with these requirements since they do not usually obtain funding by regularly tapping the capital markets.

Lastly, another significant challenge is that associated with climate change and the transition towards a more sustainable economy which, although it affects all economic agents, has a particular impact on the financial sector. Banks face two types of risks in this

[5] See *Financial Stability Report*, Spring 2019, Banco de España.

area: “physical risks” linked to the direct effect of climate change on their asset values and “transition” risks connected with the process of technological and regulatory transition to a more sustainable economy. Identifying, quantifying and mitigating these risks will require considerable effort over coming years, although the notable development of green sustainable financial markets in Spain in recent years should be underlined.

Conclusions

I shall now conclude my speech by emphasising two main ideas regarding the role of economic policies in the current situation of economic uncertainty and the importance of addressing the challenges facing the banking sector.

During my speech I have endeavoured to show that monetary policy has and continues to be effective in supporting economic activity and, consequently, inflation. However, it is necessary to underline that this cannot be the *only* lever of stimulus. Accordingly, it is imperative for national and European authorities to undertake structural reforms which improve the efficiency of the main product and factor markets and increase the euro area’s growth potential.

Likewise, given the worsening of growth projections, fiscal policy needs to provide greater stimulus to economic growth where there is scope for it to do so. It is even more important that European political authorities assess the suitability of deploying euro-area wide budgetary instruments for macroeconomic stabilisation, which would contribute to mitigating one of the main limitations in the original design of our common currency.

All these (monetary, fiscal and structural) policies may be especially effective is they are adopted jointly, thus harnessing the positive complementarities that exist between them.

As I discussed at the beginning of my speech, profitability has a direct and indirect effect on the Spanish banking sector’s resilience to adverse shocks and, therefore, on the extent to which these intermediaries can contribute to amplifying or smoothing the impact of these shocks on the economy. Consequently, it is essential for Spanish banks to address the challenges which will mark their profitability in future, such as technological change, the reduction of non-productive assets, the strengthening of capital and the improvement of their reputation.

Thank you for your attention.