Letter from the Editors

The recovery continues to gain traction in the EU and the outlook remains positive, despite lingering supply chain bottlenecks. The ECB has accordingly revised upwards its forecasts for both growth and inflation. Outside the EU, recent trends have been less favourable than anticipated due to the expansion of the Delta variant and intensification of labour shortages in the US and UK.

Under current perspectives, the main advanced economy central banks continue to see the spike in inflation as a transitory phenomenon underpinned by reversible factors such as the growth in semiconductor prices and tightening caused by the sharp turnaround of the global economy. The monetary authorities do not foresee significant changes in the factors underpinning low rates of inflation seen in recent years. Hence, the moves by the ECB and the Fed to become more flexible around their inflation targets so as to accommodate *ad-hoc* spikes. That said, although they are maintaining their positions, there is growing pressure for the main central banks to initiate tapering and a normalization of interest rates due to the increase in inflation.

Within this context, the September issue of *Spanish and International Economic & Financial Outlook (SEFO)* sheds some light on the recent increase in inflation and its impact. Specifically, we analyse the outcome of the ECB's recent monetary policy strategy review, as well as the Fed's new monetary policy strategy, announced last summer. In the case of the latter, we focus on possible repercussions for financial stability.

Annual inflation has been on an upward trajectory since the beginning of the year, with Spanish CPI increasing from negative readings in February to 3.3% in August. Rising input costs and the abrupt nature of the global recovery are primarily responsible for this trend. However, the pandemic has also accelerated nascent structural transformations, such as digitalisation and the green energy transition, entailing significant relative price changes. While energy costs have sharply risen, core inflation has remained more subdued, suggesting price growth is so far limited to imported goods, with many analysts viewing the rise in inflation as largely temporary. However, this outlook is based on three considerations relating to, first, the duration of supply chain bottlenecks and of the external cost shock, second, the possibility of second-round effects, and third, the evolution of inflation expectations. More broadly, rising inflation poses challenges for central banks. While their use of unconventional monetary policies helped reduce the impact of the crisis, it may have also constrained their ability to respond to a sustained period of inflation. Importantly, if markets perceive any weakening of central bank independence from governments' fiscal policies, this could undermine the credibility of central banks and make it more difficult to maintain the low interest rate environment.

In the case of Europe, the ECB announced the results of its monetary policy strategy review in July. Significantly, the Governing Council has adopted a 2% symmetric inflation target. However, the way monetary policy makers push back against any deviation from their target is not symmetrical. The new strategy also envisions the eventual inclusion of owner-occupied housing in its inflation calculations, though this will not take effect immediately. The strategy introduces three constraints on the Governing Council's room for manoeuvre. One stems from the 'proportionality of its decisions and potential side effects'. The second is the need to preserve the function of the monetary transmission mechanism while the third relates to the need to maintain financial stability. Lastly, the new monetary strategy places the spotlight on monetary policy interest rates, while saying less about the use of other less conventional policy instruments, like direct asset purchases or TLTROs. The distinction between these instruments matters because the logic behind any recalibration can differ and because of their role in determining the proportionality of monetary action. Lagarde may have delivered on her promise to transform how the ECB makes monetary policy, however, she will face her first major test as the ECB seeks to unwind its unconventional monetary policy instruments.

In the US, last year, the Federal Reserve amended its monetary policy to provide it with greater flexibility in accommodating its dual mandate of price and financial stability, while also increasing symmetry around the inflation target. In analysing the possible effects of the change in the Federal Reserve's strategy, the trend in sovereign bonds is key. Since the Federal Reserve announced the change in its strategy in August 2020, the yield on 10-year Treasuries has increased by a little over 50 basis points, with medium-term bond yields widening by a little less. Analysis shows that nearly 83% of the movement in the bond yield until May is attributed to the shift in inflation expectations. In addition, the term premium and real rate of interest have also exerted a structural upward impact on yields. Since the new strategy was announced, the US inflation figures have come in higher than expected while other factors (expansionary fiscal plans, vaccine announcements, *etc.*) make it hard to isolate the effect of the strategy shift on inflation expectations. Looking forward, it is likely that the new monetary policy environment will result in the 10-year US Treasury rising to a moderately high range of 2.25%-2.60%, which is unlikely to undermine financial stability.

The September *SEFO* then shifts attention over to the financial sector, in particular to the outcome of the European authorities' traditional stress tests on the European banking system, as well as provides some insights as to the debut of the ECB's climate stress tests scheduled for next year. On a related note, we assess possible explanations behind the phenomenon across banks of scant use of capital buffers during the pandemic, despite regulators' and supervisors' encouragement to do so.

This summer's European stress tests occurred at a time of shifting expectations for the European banking sector, including the return of dividend payments and a challenging monetary environment. The tests, which covered 75% of European banking assets, used the banks' common equity tier 1 (CET1) ratio as of year-end 2020 as their baseline and examined the period of 2021 to 2023. The regulators concluded that European banks have enough capital to withstand an adverse economic scenario. Banks' average CET1 ratio fell 5.2 percentage points under the adverse scenario, with credit risk, market risk, and income generation capacity the main drivers of capital depletion. The starting CET1 levels for the Spanish banks is generally lower, but capital depletion in the adverse scenario is also lower. This indicates that although the Spanish banks continue to present slightly below average capital ratios, they are more resilient than the average European bank. Importantly, the results of these tests will influence Pillar 2 Guidance and the Supervisory Review and Evaluation Process. On top of these pressures, banks will have to contend with an uneven regulatory environment with FinTechs and growing sensitivity surrounding ESG-related issues.

The ECB's first round of climate stress tests in 2022 will consider two classes of risks stemming from climate change – physical risks and transition risks. To the extent that climate risks impact banks' ability to meet their capital requirements and execute their strategic plans, it is necessary to assess banks' resilience to different climate change scenarios. Importantly, these tests differ in several ways from the conventional biannual stress tests. Firstly, the ECB and not the EBA will design the tests, engage with banks and report the results. The climate tests will provide the supervisor with an initial assessment of the state of play in the banking system and an idea of its capital sufficiency in the event of adverse climate scenarios. Although the climate tests will apply to all significant institutions, there will be some variation. Notable changes are also anticipated, mainly affecting the banks' ability to identify relevant information related with the climate impact of their investment portfolios. Lastly, the scenario used will be determined by the Network for Greening the Financial System (NGFS). Given the novelty of the tests, coupled with data insufficiency and heterogeneity, it is likely that the results for the banks tested will vary widely based both on geographical location and sectors. Looking forward, the future integration of climate risks into the mainstream stress tests is a distinct possibility.

One of the fundamental new aspects of Basel III compared to its previous iterations is the introduction of capital buffer requirements. While most capital buffers are set either as a fixed amount or established during the supervisory cycle, the countercyclical buffer can be adjusted in a discretionary manner depending on economic trends. Due to the unprecedented nature of the COVID-19 crisis, regulators and supervisors permitted banks to utilise their capital buffers, including the countercyclical buffer. Despite also curbing dividend payments and committing to a generous timeframe to allow banks to replenish their initial capital positions, banks have not taken advantage of the more flexible treatment of capital buffers. Results from econometric analysis show a reduction in an entity's capital ratio is penalised by the market, confirming the hypothesis of a 'stigma effect'. However, if it is accompanied by a reduction in regulatory capital and the entities continue to hold the same margin over the minimum required, that penalty is mitigated. These findings suggest regulators should consider fine-tuning the current buffer system to increase releasability.

Finally, we analyse the impact of COVID-19 on Spain's external sector, particularly the extent to which the COVID-19 crisis has shifted the Spanish economy's international competitiveness, creating new opportunities for Spanish businesses. While the drop in Spanish imports and exports post-COVID-19 (close to 40% year-on-year) was comparable to the contraction sustained in the wake of the Global Financial Crisis of 2008, the rebound, with year-on-year growth in exports of over 70% in April 2021, has been far more dynamic. This raises the question of whether Spain is simply catching-up after trade flows were interrupted in 2020 or whether this is the beginning of a significant structural change in Spanish trading patterns. Although it is still too soon to provide a clear answer to that question, initial data point to a structural shift. Spain's long-standing non-energy trade deficit turned into a surplus in the first half of 2021. Additionally, the food industry was the sector which made the biggest contribution to the recovery in exports, fuelled mainly by non-EU markets. The fact that the food sector is a core component of Spain's export effort, and has a history of robust export oriented productive capacity, is a possible indicator of a structural improvement in the Spanish economy's international positioning.