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Economic and financial background

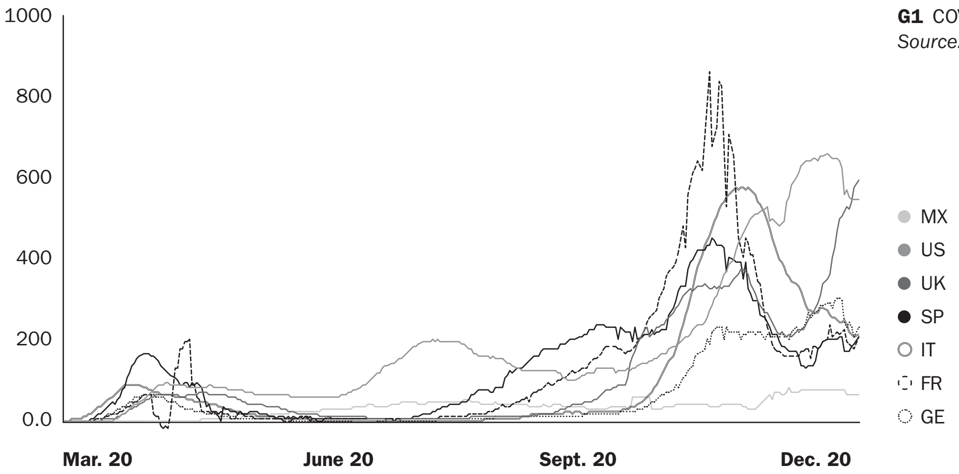
The COVID-19 health crisis was the main factor shaping the performance of the global economy and financial markets during the year. The economy experienced an unprecedented slump in 2020. Moreover, Brexit-related uncertainty persisted, but was finally resolved with an agreement on future relations between the United Kingdom and the EU. Tensions persisted between the United States and China, and Donald Trump was defeated by Joe Biden in the US presidential elections.

COVID-19 and scientific research

The pandemic spread rapidly and widely across the globe early in the year, overwhelming hospitals and putting most of the world economy into lockdown between March and April. The gradual improvement in the situation made it possible to re-open the economy gradually as the summer approached. However, the situation in the major developed economies deteriorated again in the autumn. Daily infection rates peaked, and in some areas hospitalisation rates for COVID-19 exceeded the record levels seen in the spring.

As a result, governments reintroduced containment measures, albeit less aggressively than during the first wave. The response to the second phase was supported by hospital protocols already in place, distancing and hygiene measures, and the greater availability of information about how the virus spreads. Moreover, unlike the first wave, the virus had little impact in China or some developed Asian countries due to mass testing and strict control of disease spread, the contact chain and international borders.

COVID-19 resulted in an unprecedented decline in economic activity.



G1 COVID-19 cases.
Source: Our World in Data

The scientific community engaged fully from the outset in the search for a vaccine or an effective treatment for COVID-19, as well as investigating the virus in depth in order to enhance control and prevention. This effort by both the public and private sectors bore fruit, resulting in the production of vaccines (by Pfizer, BioNTech and Moderna, among others) and drugs by year-end — unprecedented speed for a process that normally takes years. Vaccine supplies began to arrive in most developed countries towards the end of the year.

Response by the economic authorities

The authorities generally responded swiftly and forcefully to the crisis in order to mitigate its economic effects and ensure financial stability.

— Central banks engaged in exceptionally accommodative monetary policies, with sizeable injections of liquidity into the financial markets.
— National governments adopted clearly expansionary fiscal policies, with measures to strengthen healthcare systems, guarantee funding for business, and protect jobs and household incomes.
— As for the European Union (EU), in addition to suspending the fiscal rules to which the member states are subject, the Next Generation EU (NGEU) recovery plan represents an important step in terms of European construction and is a new mechanism for economic stabilisation at European level.
— Supervisory authorities introduced flexibility in the use of capital and liquidity buffers and in the interpretation of accounting standards, and temporarily eased supervisory pressure.

Monetary policy in developed countries

In the Eurozone, the ECB adopted a number of measures with the aim of minimising the economic cost of the crisis, boosting inflation, giving countries fiscal leeway, avoiding fragmentation in financial markets and, as far as possible, minimising the impact of negative interest rates on banks. Accordingly, the ECB launched a new asset purchase program (PEPP), which it increased and extended twice, augmented the previous program (QE), improved the characteristics of the TLTROs, created new liquidity operations and relaxed collateral rules.

In the United States, the Fed deployed a wide range of measures aimed at facilitating dollar liquidity, the flow of credit to the economy and the functioning of financial markets. In fact, with those facilities, the Fed positioned itself as a lender of last resort not only to the market, but also directly to households and businesses. The Fed introduced an unlimited asset purchase program, resumed some of the liquidity mechanisms used during the global financial crisis, and took other steps such as purchasing corporate debt in both the primary and secondary markets.

In the UK, the Bank of England (BoE) cut its base rate by 65 basis points to 0.10% and extended the asset purchase programme by 450 billion pounds. The BoE also extended liquidity facilities to banks and building societies with special incentives for lending to SMEs, bought commercial paper from large companies, and reduced the countercyclical capital buffer to 0%. The BoE is also working on the possibility of letting interest rates go into negative territory, although its Governor does not see this as a tool for immediate implementation. The Bank of England also coordinated its monetary policy measures closely with fiscal policy measures.

The Bank of Japan (BoJ) introduced an unlimited asset purchase programme while increasing the volume of purchases of commercial paper, corporate debt, ETFs and J-REITs, and created a special facility to guarantee funding for companies affected by COVID-19, with a special focus on SMEs. It also introduced an innovative monetary policy tool to encourage bank mergers.

Fiscal policy in developed countries

The scale of the fiscal response in the various Eurozone countries was shaped by their initial budgetary position. Germany was one of the countries with the most forceful measures. In Spain, aid took the form mainly of guaranteed loans to enhance companies' liquidity and of measures to preserve household incomes, such as furloughs.

In addition, the European Council resolved in July to create Next Generation EU (NGEU), a recovery plan amounting to 750 billion euros to address the economic and social consequences of the pandemic and mitigate the asymmetrical effects of the crisis in EU Member States. The decision was formally adopted at the end of the year together with the new EU budget for the period 2021-27. NGEU will provide transfers and loans to countries, based on such factors as per capita income and the economic impact of the pandemic. Countries must submit investment projects and structural reforms aligned with EU priorities. In Spain, the government announced that it will channel 72 billion euros between 2021 and 2023.

Europe gave the green light to the Next Generation EU (NGEU) fund, an important step forward in European construction.

The United States adopted a determined fiscal response, resulting in its largest deficit since 1945. In the United Kingdom, the main measures focused on wage subsidies for activities interrupted by COVID-19 and government guarantees for loans to SMEs. The fiscal measures ultimately amounted to over 19% of GDP.

Other issues in 2020

The health crisis reignited tensions between the United States and China. As COVID-19 spread in the United States and its economic impact became clear, President Trump stepped up his criticism of China as the origin of the virus and for its handling of the pandemic in its early stages. This did not lead to an escalation of the trade war, which remained subdued during 2020, but it did result in action against Chinese companies, mainly in technology; for example, the United States prohibited the sale to Huawei of chips by any company, domestic or foreign, that used American technology or equipment to produce them. The dispute also spilled over into the geopolitical realm as a result of China's more aggressive foreign policy in Hong Kong and, to a lesser extent, Taiwan.

Uncertainty about Brexit persisted for most of the year. Shortly after the UK formally left the EU on 31 January, when the transition period commenced, negotiations on the future relationship between the UK and the EU were interrupted by COVID-19. Negotiations resumed later in the year and, at year-end, the UK and the EU had reached a basic agreement that avoided a "hard" Brexit.

The EU and the United Kingdom reached an agreement on their future relationship that provided for an orderly exit from the transition period.

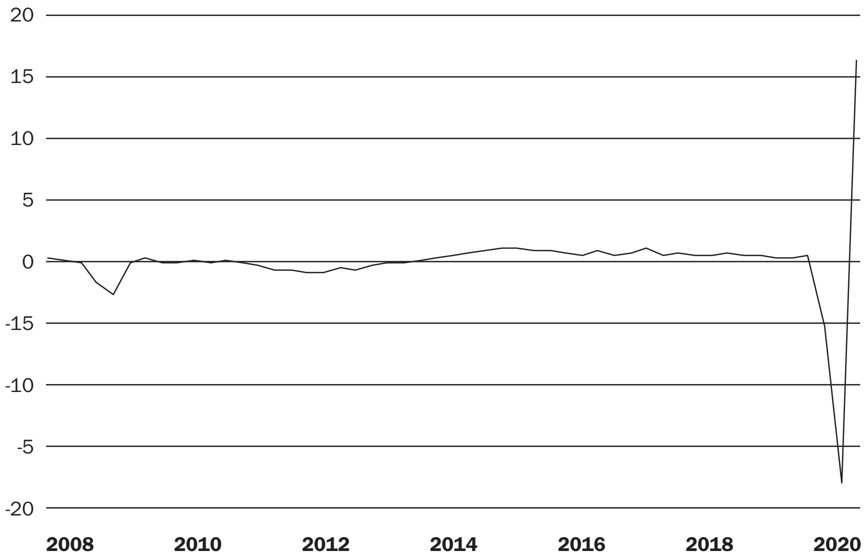
The US presidential election in November was a turning point in domestic politics and in multilateral relations at an international level. Democrat Joe Biden won the election, having obtained more votes than any presidential candidate in US history. At the legislative level, the Democratic Party retained control of Congress, while control of the Senate remained in the balance until January. The new Administration aims to restore international multilateral relations in general, although it continues to view China with scepticism. Biden's agenda also focuses on the fight against climate change and includes the US rejoining the Paris Agreement.

Economic activity and inflation

World GDP registered an unprecedented decline of over 4.0% in 2020. The severity of the recession was due to the confluence of a number of factors: combined supply and demand shocks, together with a large uncertainty shock and substantial financial stress. Moreover, this crisis was highly asymmetric across sectors, agent classes and many other dimensions. Unlike previous crises, industry fared relatively better, while services, especially those involving physical contact (foodservice, leisure, tourism and travel, etc.) were hit hardest. This also explains why international trade shrank by less than GDP as a whole and managed to rebound strongly in the second half of the year. Approaches to managing the crisis also led to differences between countries' economic performance, with most Asian countries standing out in positive terms. The crisis had a greater impact on the most vulnerable and disadvantaged, who were affected more in terms of both finances and health.

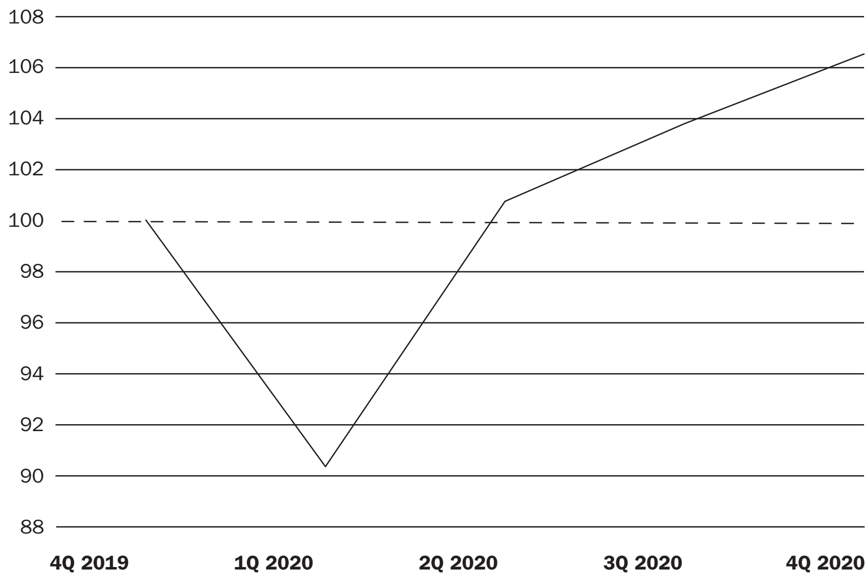
In developed economies, the record slump in activity in the first half of the year was followed by a strong rebound in GDP in 3Q20 due to de-escalation and a weak 4Q20 as the pandemic worsened and further containment measures were imposed. GDP in the major developed countries ended the year below pre-COVID-19 levels. Economic performance in the Eurozone differed between countries as a result of such factors as: (i) differing degrees of laxity in the containment measures; (ii) different production structures and industry specialisation; (iii) different scales of fiscal response; etc. In the UK, GDP fell by more than 25% between February and April. In the United States, the economic contraction was less severe than in Europe, supported by strong fiscal stimulus and laxer measures to control COVID-19.

Spain was one of the European economies that was most affected by the crisis due to its high exposure to tourism and small companies, and to the initial severity of the COVID-19 containment measures. In the first half of the year, Spain registered the largest decline in GDP among the large Eurozone economies. GDP fell by more than 10% year-on-year in 2020 as a whole. Furlough programmes limited job destruction and enabled the labour market to perform better than in previous crises. National exchequers were severely affected by the decline in tax revenues and, above all, by the increase in spending aimed at safeguarding household and company incomes.



G2 Spain GDP.
(q/q change, %)
Source: INE

Emerging economies also experienced an unprecedented decline in economic activity. The negative impact was lowest in the Asian countries thanks to their rapid and effective containment of the virus. As a result, China led the global economic recovery and is one of the few countries that has already regained pre-pandemic GDP levels. Latin America, which had already been experiencing some economic stagnation, has not managed to get the virus under control and the crisis has exacerbated structural problems such as inequality and social discontent. The vast majority of emerging central banks responded by easing monetary policy in line with the measures adopted by the developed countries. The fiscal response, however, was not as coordinated or aggressive. Brazil, for example, with its already weakened public accounts, opted for a strong fiscal stimulus, while Mexico's response has been practically nil.



G3 China GDP
4Q19 = 100.
Source: Bloomberg

In Mexico, the crisis led the three main rating agencies to downgrade the sovereign credit rating, although it managed to retain investment grade. Following the sizeable impact on the economy in the second quarter, the economic recovery was supported mainly by external demand and the automobile industry, in a context in which the new NAFTA agreement finally came into force on 1 July. Aside from COVID-19, López Obrador's nationalist strategy in energy has hurt private investor confidence in this sector. GDP fell by around 9% in the full year. Elsewhere in the emerging countries, Turkey's economic and financial situation is still particularly delicate, although the markets welcomed the change in government's shift to a more orthodox economic policy towards the end of the year.

Although inflation is harder to read because of changes in spending patterns, it has been pressured downward in the developed countries by the impact of COVID-19 on demand. Inflation in the Eurozone moved into negative territory for the first time since mid-2016, while core inflation (excluding energy and food) reached record lows. Inflation was weighed down not only by the deterioration in the economy but also by aspects such as the temporary reduction in VAT in Germany. In the United States, core inflation reached its lowest level since 2011. As the economic recovery in the US advanced, inflation has begun to rise.

The price of crude oil reached its lowest in several years in the early phase of the crisis, with the Brent approaching 19 dollars per barrel in the face of lockdowns and sharp declines in mobility in a large part of the globe. The subsequent economic recovery, the de-escalation and the willingness of major producers to adjust output to avoid a glut enabled the price to recover much of the lost ground and to end the year slightly above 50 dollars per barrel.

Financial markets

The financial markets were strongly impacted at the beginning of the year by the global COVID-19 effect. The surge in risk aversion was comparable only to what was observed during the global financial crisis, with plummeting sovereign bond yields, sharp corrections in risk assets and a marked increase in tensions in short-term funding markets. In addition, the primary market in corporate bonds closed and there were worrying episodes of illiquidity in several markets, including those that had been considered to be the deepest.

Liquidity measures introduced by central banks led to a normalisation of short-term funding markets and enabled bank credit to continue to flow to the private sector. The economic support measures implemented by the authorities, together with the control of the pandemic in the developed economies before the summer, the revival of economic activity and, later, news of treatments and vaccines against COVID-19, managed to stabilise the markets and allow risk assets to recover (albeit with considerable differences between sectors and countries). The outcome of the US presidential election and the achievement of a Brexit deal in the latter part of 2020 were also supportive. Against this backdrop, corporate spreads performed very well, closing the year very close to pre-crisis levels and with record issue volumes in 2020 as a whole.

Germany's long-term government bond yields fell over the year as a whole to an all-time low (-0.86%), influenced by the crisis and the ECB's asset purchase program. Yields were boosted somewhat by the announcement of fiscal stimulus measures in Germany and the creation of the EU recovery fund, as well as positive news on the development of a COVID-19 vaccine. In the United States, government bond yields trended downwards in the early months of the year to a record low (0.52%), assisted by the Fed's aggressive intervention in this market. Yields were driven upwards at the end of the year by, among other things, expectations of additional fiscal stimuli and positive news regarding vaccine development.

Sovereign risk premia in non-core Europe ended the year at their pre-COVID levels, after surging at the beginning of the pandemic. Risk premia were supported by the increase and extension of the ECB's asset purchase programmes and the agreement reached on the EU recovery fund. The Spanish government 10-year bond yield went into negative territory for the first time ever.

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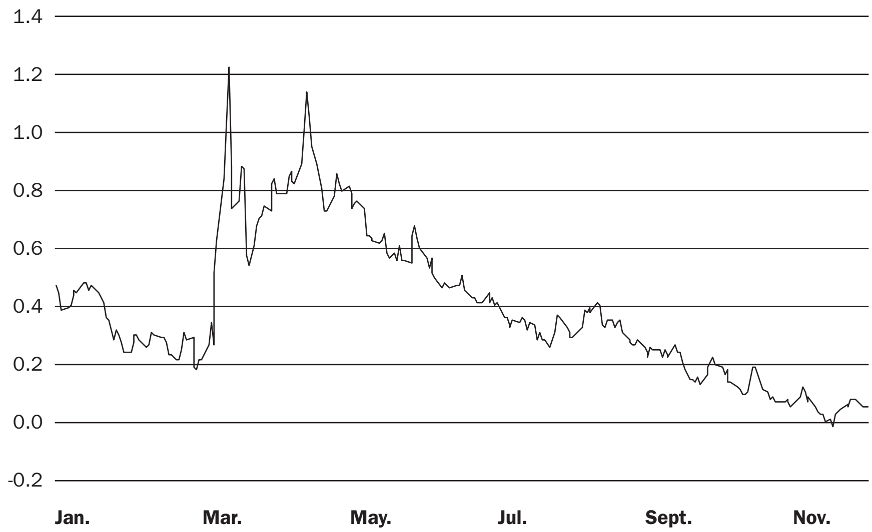
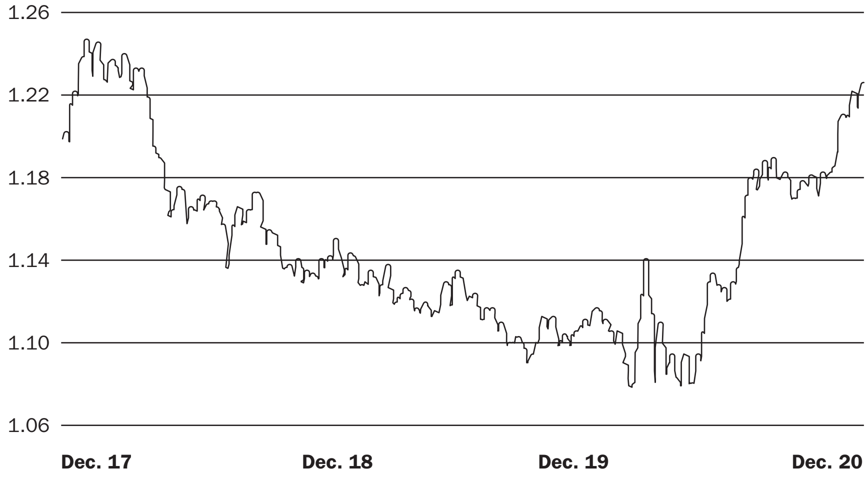


G4 Spanish 10Y government bond yield. (%).
Source: Bloomberg

The currency market experienced considerable volatility. The global shortage of dollars after the outbreak of the crisis pushed the dollar sharply upwards, a trend that was reversed by the swap lines implemented by the Fed. The euro started to strengthen directionally against the dollar after the announcement of the European recovery plan. This appreciation continued in the context of a generally weak dollar, which was driven by the zero interest rate environment in the United States, Biden's victory in the presidential elections and the prospects of a global economic recovery.i As a result, the dollar lost 9% against the euro in the year, closing at 1.22 USD/EUR, its lowest since 2018. Sterling was particularly sensitive to the COVID-19 crisis, in line with its performance in other periods of risk aversion, although it was also reflecting the particularly severe impact of the crisis on the UK economy. Sterling depreciated sharply against the euro in the first half of the year, but this was gradually reversed in the second half. Uncertainty about Brexit also weighed on sterling, as did the Bank of England's debate over the possibility of setting negative interest rates. As Brexit negotiations advanced, sterling recovered somewhat but was still down 5% against the euro at year-end.



G5 USD/EUR.
Source: Bloomberg

Equity markets were hit hard by the outbreak of the crisis. Share prices corrected sharply, particularly in the sectors that were hit hardest by lockdowns and border closures. The adoption of accommodative measures by the authorities enabled equities to rally strongly. Some indices, such as the S&P500 and NASDAQ, even surpassed pre-crisis levels and closed the year at record highs. Asian stock markets also ended 2020 with significant gains. Europe equities were the main laggards, most ending the year in negative territory, given the more cyclical nature of their assets and the poor performance by the banking sector. The FTSE 100 (-14%) and the IBEX 35 (-15.5%) registered their worst performance since 2008. Meanwhile, the DAX only managed to gain 3.5%.

Financial markets in emerging economies also felt the impact of the strong monetary and fiscal expansion worldwide. A new supportive feature was the implementation of asset purchase programmes by some emerging countries' central banks. Moratoria on debt repayments also provided a respite for some of the poorer countries. Meanwhile, Biden's victory in the United States and the news regarding the development and distribution of vaccines supported capital flows towards emerging economies. As a result, although underlying financial vulnerabilities persisted, sovereign and corporate risk premia returned to very close to pre-COVID-19 levels.

Banking sector

> The banking industry played a key role in addressing the crisis, which it entered with fundamentals that were undeniably stronger than in 2008.

The banking sector took on a key role in the solution to the economic problems caused by the exogenous shock of COVID-19, by mobilising all its resources to ensure that those affected by the crisis, especially the most vulnerable, could benefit without delay from the guarantees, sureties and moratoria approved by governments and by the industry itself.

European banks entered this crisis with fundamentals that were undeniably stronger than in 2008, in terms of the quantity and quality of capital as well as liquidity and leverage. The NPL ratio continued to trend downward, reaching its lowest level since the European Banking Authority (EBA) began publishing figures (June 20: 2.8%), confirming the asset quality improvement and balance sheet repair.

In its autumn Financial Stability Report, the Bank of Spain concluded that the Spanish banking sector is capable of withstanding the sizeable economic impact of the health crisis. In both the baseline and adverse scenarios of its analysis, all banks would have CET1 ratios above the regulatory minimum of 8 percentage points.

However, the macroeconomic consequences of the pandemic — such as the prolongation of the period of low interest rates and the expected rebound in credit risk

— will persist over time, posing an additional challenge to bank profitability, which remains depressed. As a result, in a context of economic deterioration and high uncertainty, the banking sector has significantly increased the level of provisions.

Regulatory environment

Banking Union

In 2020, Bulgaria and Croatia joined the Banking Union (BU) and, consequently, became part of the Single Supervisory Mechanism (SSM) through the close cooperation mechanism, and those countries' systemically important banks came under the direct supervision of the ECB.

At an institutional level, the Eurogroup confirmed that progress is being made on technical issues with regard to liquidity in resolution, and the role of the European Stability Mechanism (ESM) as a back-up to the Single Resolution Fund (SRF) was formalised. The European authorities' work plan for 2021 prioritises advancing towards completion of BU. A number of European authorities, including the SSM and the Bank of Spain, have reiterated the urgency of completing Banking Union in the current institutional cycle (i.e. before 2024) and have considered the creation of a European Deposit Guarantee Scheme (EDIS) as a priority.

The agreement on the European recovery fund is expected to provide considerable impetus to the completion of BU, insofar as it limits the strengthening of the sovereign-bank link and creates, *de facto*, a European common safe asset that should foster financial integration.

Capital Markets Union

In the autumn, the European Commission presented the Capital markets union new action plan, with which it intends to make a decisive contribution to the post-COVID economic recovery. The Plan has three main goals: (i) support a green, inclusive and resilient economic recovery by making financing more accessible to European companies; (ii) improve the EU's capacity for long-term saving and investment; and (iii) integrate national capital markets into a genuine single market.

Macroprudential framework

Macroprudential policy has gained in importance in the current context of rising risks to financial stability. The COVID-19 crisis was, in fact, the first major test to the global financial banking system after the Basel reforms that followed the financial crisis and the introduction of the macroprudential approach to regulation. The consensus is that, overall, the framework has proved to be resilient and has enabled banks to perform their vital function of providing credit to the real economy.

The benefits of unwinding some macroprudential capital buffers in Europe have reignited the global debate on the actual usability of bank capital buffers in times of crisis. The ECB considers it necessary to reconfigure the current composition of capital requirements and advocates increasing the level of countercyclical capital buffers (CCyBs), while decreasing the level of other buffers (e.g. bank-specific or Pillar 2 buffers). Moreover, it believes that the accumulation of releasable capital buffers can effectively complement monetary policy actions during a crisis, especially in the current context of prolonged low interest rates.

With regard to rebuilding buffers, the process of capital accumulation to pre-COVID levels is expected to be very gradual. In this regard, the Bank of Spain has decided to keep the CCyB in abeyance until the economic and financial effects of the pandemic have dissipated.

The non-bank financial intermediation sector has continued to grow overall, especially in the provision of credit in the Eurozone. Moreover, there is a persisting high level of interconnections between this sector and the banking sector, which may entail risks even under normal market conditions. Globally, this sector generated several episodes of stress in the financial markets in the early stages of the COVID-19 crisis. Consequently, the ECB and other bodies, such as the Financial Stability Board (FSB), advocate complementing and expanding the macroprudential framework so that national authorities have the necessary tools to limit that sector's effect of amplifying volatility and liquidity risks that was observed during the crisis.

Regulatory and supervisory framework

In the face of the COVID-19 outbreak, international, European and domestic authorities in the financial sector adapted their work plans, took measures and issued recommendations to ensure institutions' operational continuity as well as financial stability as a whole. At global level, both the Basel Committee on Banking Supervision and the FSB postponed their schedule of main regulatory reforms by one year.

In Europe, banking supervisory policy made use of some of the flexibility provided for in the rules, with the ultimate aim of not restricting credit and of allowing banks to enable households and businesses to benefit fully from the guarantees, sureties and moratoria approved by government authorities and banking associations. The SSM decided to allow banks to fully utilise some capital and liquidity buffers and introduced supervisory flexibility in relation to the prudential treatment of COVID-19 related lending. It also adjusted the calendar of supervisory activity, postponing resource-intensive exercises (such as stress tests and the implementation of some pending regulatory measures), temporarily reducing on-site inspections at institutions and relaxing the deadlines for the delivery of supervisory data or disclosures to markets and the publication of financial information. The SSM also recommended that banks should not distribute dividends or buy back shares until 30 September 2021. Starting in the third quarter of 2020, the SSM shifted its supervisory approach to focus on assessing the risks, vulnerabilities and potential impact of the pandemic on the credit risk in bank balance sheets.

Supervisory policy took advantage of some of the flexibility provided by the rules and also recommended against dividend distributions and share buybacks.

Given the impending disappearance of LIBOR and EONIA at the end of 2021, the authorities have stepped up pressure to ensure a smooth transition. With a view to the discontinuation of LIBOR in 2022, the European Commission presented a proposal to amend the Benchmark Regulation (BMR) to ensure that the disappearance of such a critical benchmark does not disrupt the economy or the financial system.

With regard to Brexit, the European and UK authorities expect to sign a Memorandum of Understanding (MoU) on financial regulation in the first quarter of 2021. This new relationship in the financial area will be based on specific equivalences, which will continue to be negotiated beyond 2020. In any event, the measures adopted during the transition period ensure the continuity of the provision of financial services between the two jurisdictions after Brexit.

Central banks, regulators and supervisors have increased pressure on financial institutions to assess and disclose the threat of climate risks to their business models so that these risks can be optimally managed. The SSM published its supervisory expectations on climate-related and environmental risks and is working to incorporate these risks into its stress tests, while the EBA is conducting a climate risk sensitivity exercise on banks' holdings in large corporations. The EU has made progress in developing the regulatory framework for sustainability and the European Commission has revised its sustainable finance strategy. In Spain, the Climate Change and Energy Transition Law, which is currently going through Parliament, will impose climate reporting requirements on the financial sector.

Outlook for 2021

Concerns about COVID-19 can be expected to fade in 2021 as the population is vaccinated.

Economies are expected to perform well generally, especially from the second quarter onwards.

The ECB is expected to maintain a clearly accommodative monetary policy with no change in official interest rates.

With regard to financial markets, government bond yields may trend upwards, although they should remain contained in a context of financial repression.

Risk premia on peripheral government debt are expected to be supported by ECB policy and the presence of the Recovery Fund.

The US dollar could depreciate against the euro in the face of progress in European construction, the context of zero interest rates and the change of government in the United States, among other factors.