Economic, business and regulatory environment

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The year 2021 has continued to be marked by the COVID-19, although it has become less central to the economy thanks to vaccination.

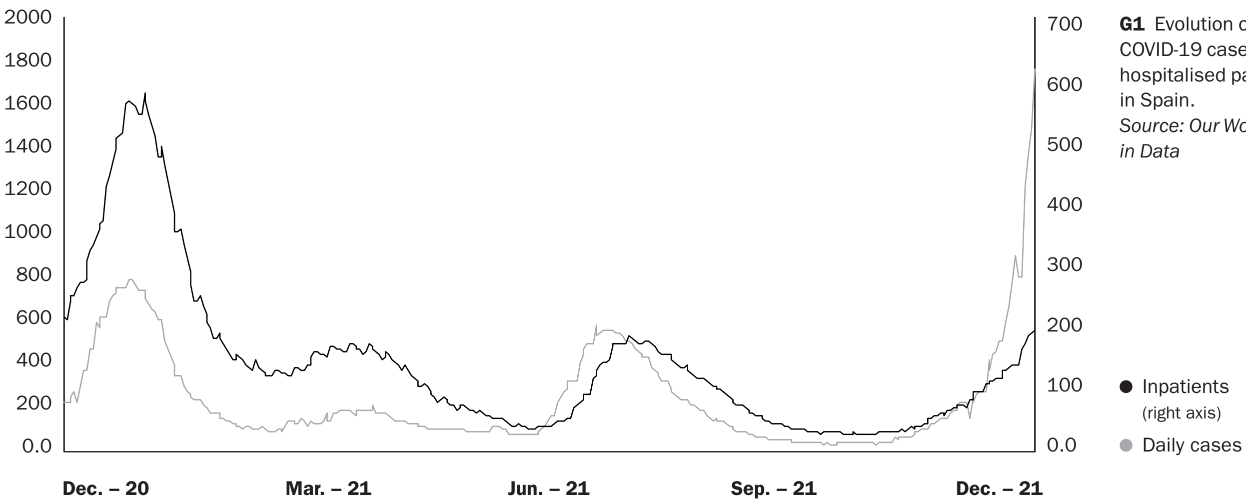
Economic and financial background

The year 2021 has continued to be marked by the COVID-19 pandemic, from the expansion of the alpha variant at the beginning of the year to the omicron in the final part of the year. In any case, COVID-19 has been losing its central role as a determinant of economic activity and financial markets. In terms of activity, developments have been generally favourable thanks to the process of economic reopening, albeit uneven at the global level. For its part, the pick-up in inflation has been one of the most notable surprises of the year and one of the most important market factors. The high levels of inflation eventually led to a shift in monetary policy, first in many emerging countries and later in developed countries. Overall, 2021 has been a positive year for financial markets.

Evolution of COVID-19

The pandemic has remained present throughout 2021. Countries faced successive waves of infections and the emergence of new variants of the virus, adding to uncertainty about the future evolution of the pandemic. Progress in the vaccination process, which gained momentum from the first quarter onwards, did not eradicate the pandemic, but it did have positive effects in reducing the rate of hospitalisations and deaths, making the consequences of the pandemic more manageable. Thus, the containment measures imposed were more limited as new waves occurred, although some measures aimed at the unvaccinated population were more restrictive in the last months of the year, with the aim of increasing the percentage of the population vaccinated.

The effectiveness of vaccines made them the main tool for controlling the pandemic, although their distribution around the world has been very uneven. While third booster doses were already being distributed in developed economies by the end of the year, in many emerging countries satisfactory percentages of the population had not been reached with the initial two-dose vaccination schedule.



G1 Evolution of daily COVID-19 cases and hospitalised patients in Spain.
Source: Our World in Data

This left these countries vulnerable, and they were the origin of variants of the virus that later spread globally, such as Delta (India) or Omicron (South Africa). This last variant was the cause of a new wave of global infections in the final stretch of 2021, which brought the number of new daily cases detected to the highest levels of the entire pandemic, although the pressure on the health system remained more contained at the end of the year than in previous waves.

Inflation has surprised on the upside and has reached high levels in many countries.

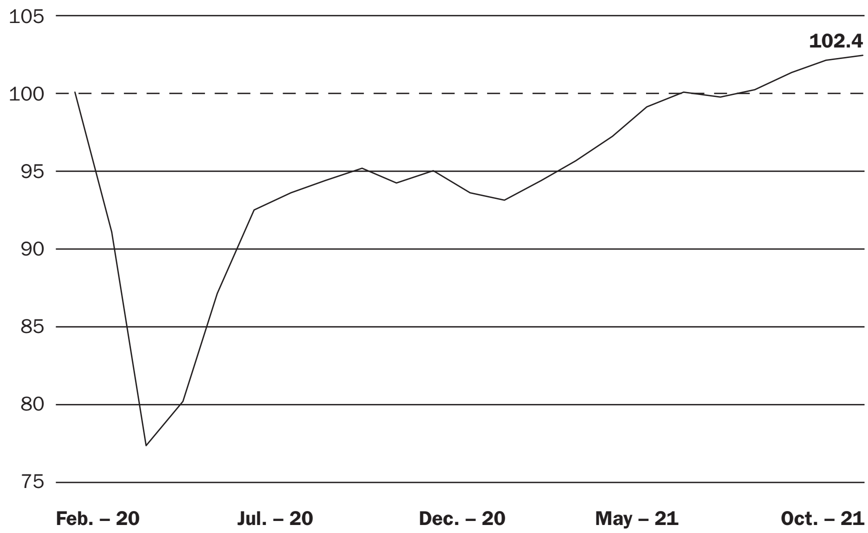
Economic activity and inflation

Global economic developments have been generally favourable in 2021, with developed countries standing out on the positive side. This has been due to the positive effects of the increased control of the pandemic, the reopening of economies and the high fiscal stimulus introduced. The latest contagion waves had a limited impact on demand. In contrast, zero COVID-19 policies in Asia – mainly in China – partially paralysed production and transport processes, affecting international production chains.

In the Eurozone, GDP will have grown by around 5.0% in 2021, around pre-COVID levels. In addition to the vaccination campaign, activity has been supported by favourable financing conditions and the expansionary fiscal policy stance, which has been helped by the implementation of the Next Generation EU (NGEU) programme. For their part, problems in global production chains and waves of contagion limited economic growth. In the political sphere, the arrival in power in Italy of M. Draghi, former president of the European Central Bank (ECB), and the formation in Germany of a new coalition government made up of the SPD, the Greens and the Liberals, with a more constructive approach to European integration than the previous government, stood out. In the United Kingdom, the economy also showed strong growth for the year as a whole, with the labour market and the real estate sector performing particularly well. Brexit accentuated the disruptions to supply chains caused by the pandemic. Following the trade agreement reached at the end of 2020 between the UK and the European Union (EU), tensions over the part affecting the Northern Ireland protocol required some relaxation of the terms of the agreement. The issues surrounding this protocol have not been resolved. In the United States, the extraordinary support from fiscal and monetary policy allowed the economy to experience a robust recovery and activity to return to the pre-COVID level in the second quarter. On the fiscal front, a new stimulus package was approved in the first quarter, equivalent to almost 9 % of GDP and including, among other things, direct aid to households and small businesses. Subsequently, the focus was put on promoting investment in infrastructure in order to boost potential growth.

The Spanish economy has shown a favourable evolution, with the number of employed persons above the pre-crisis level.

In Spain, GDP will have grown by around 5% in 2021, after falling by more than 10% in the previous year. In the early part of the year, the economy showed weakness due to the restrictive measures taken to combat the third wave of COVID. The situation subsequently improved with the advancement of the vaccination process and the progressive opening of the economy. In the latter part of the year, rising energy prices, bottlenecks in global value chains and the spread of the Omicron variant of the coronavirus limited activity growth. With regard to the labour market, employment evolved favourably throughout the year and returned to pre-pandemic levels. In the area of economic policy, measures were approved in March to strengthen the solvency of companies to the tune of 11 billion euros (direct aid, aid for the restructuring of guaranteed financial debt and the creation of an SME recapitalisation fund). In the middle of the year, the European Commission (EC) approved Spain's Recovery Plan associated with the NGEU funds, from which it expects to receive around 70 billion euros in the form of transfers in the coming years. Finally, the new labour reform, which incorporates a new system of permanent Spanish furlough scheme (ERTE) and aims to limit temporary employment, stands out. There was also a reform of the pension system, from which the CPI is again used as the revaluation mechanism and incentives are introduced to delay the retirement age.

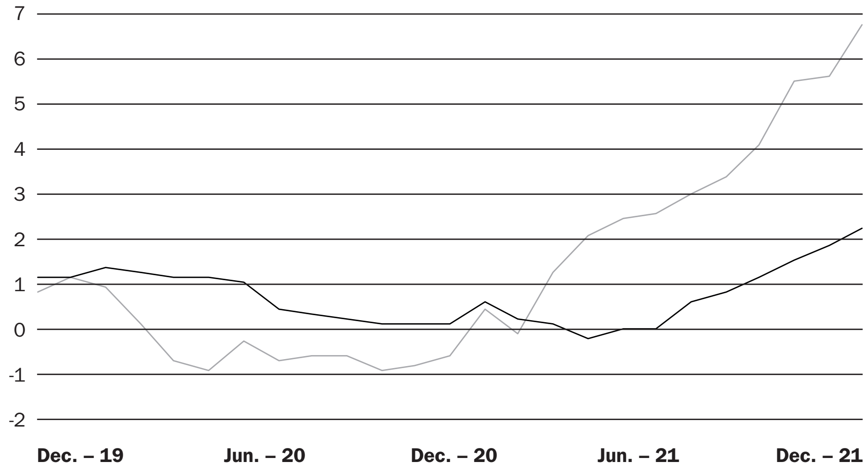


G2 Effective affiliation (without ERTE) to Social Security in Spain.
February 2020 = 100.
Source: Ministry of Inclusion, Social Security and Migration

In emerging economies, some countries recovered pre-COVID GDP levels – including some Latin American countries – after China did so as early as the end of 2020. If anything, economic developments in many of these countries have been weak. This is because of poorer health conditions, the impact of the pandemic on the global tourism sector, the reduced capacity to perpetuate economic stimulus in these countries, and the impact in terms of poverty and inequality. Moreover, in the case of China, consumption has remained weak due to zero COVID-19 policies, compounded by the negative impact of the adjustment of the real estate sector and the regulatory tightening promoted by the authorities and aimed at reducing economic and financial imbalances. Faced with the threat that these developments could systemically affect the Chinese economy, and given the significant slowdown in the last part of the year, the authorities adopted a laxer discourse with the aim of "stabilising" the economy by 2022. Finally, Mexico has stood out positively for its low fiscal, financial and socio-political vulnerabilities compared to other Latin American countries, as well as for its high linkages with the United States.

Inflation became increasingly important in 2021. It surprised on the upside and reached very high levels in some cases. The price increase was the result of several forces. First, the rapid recovery in demand, channelled to a greater extent towards the purchase of goods, met with a relatively inelastic supply and difficulties to adjust, leading to the emergence of bottlenecks in some sectors (e.g., shipping and semiconductors). On the other hand, supply disruptions caused by production shutdowns in Asia, labour shortages in some areas (e.g., logistics and primary sector) and certain weather events led to supply problems and contributed to price increase. Finally, the contribution of commodities to inflation is noteworthy, having experienced the largest increase in commodity prices in 40 years. In the second part of the year, Europe experienced an energy shock due to high energy demand and geopolitical issues. As a result, the price of natural gas in Europe reached historically unprecedented levels. Meanwhile, oil stood out with a 50% increase per annum, the strongest gain since 2016, while industrial metals had their best performance since the financial crisis. Agricultural commodities also recorded decade-high gains, boosting global food prices.

In the Eurozone, inflation rose almost constantly throughout 2021 and the Harmonised Index of Consumer Prices (HICP) stood at 5.0% in December, the highest rate since the beginning of the series in 1997. Most of the increase was explained by the energy component, as a result of the sharp rise in the price of natural gas. The reversal of the VAT cut in Germany was also a contributing factor in keeping inflation at elevated levels. The underlying component also increased, albeit to a lesser extent. In Spain, the increase in inflation was also strongly determined by energy and, in particular, by the increase in electricity prices. Electricity accounted for about 40% of the increase in the HICP in 2021 and drove it to the highest rates since 1992 (Dec-21: 6.6% year-on-year). In the United States, inflation in December was at a 40-year high. Inflationary pressures have been very broadly based by item, with some of the most persistent effects such as rents standing out. In addition, significant wage pressures have started to emerge as a result of labour shortages.



G3 HICP for Spain (year-on-year change in %).
Source: Spanish National Statistics Institute.

Monetary policy

The context of higher inflation has led to a shift in the monetary policy of central banks.

The major central banks have maintained an accommodative monetary policy, although they have started to move forward with their exit strategy from the stimulus measures implemented during the pandemic, especially in the second half of the year in the high inflation environment.

In the Eurozone, the ECB reduced the pace of asset purchases through the PEPP (a programme implemented during the pandemic) and confirmed that it will end in March 2022. Following the end of the PEPP, the ECB will temporarily increase traditional Quantitative Easing (QE). The Bank also signalled that the special conditions applied to TLTRO III (minimum rate of -1.00%) will not be extended beyond June 2022. With regard to inflation, the central bank has maintained that its increase is temporary, although the growing concern was seen among its members. The ECB has thus insisted that it is unlikely to raise interest rates in 2022. Finally, the central bank presented its new monetary policy strategy. The ECB adopted a medium-term inflation target of 2% and acknowledged that it may temporarily allow for moderately higher inflation. It set a symmetrical target, which means that the ECB considers "negative and positive deviations of inflation from 2% to be equally undesirable". The central bank also indicated that financial stability is a precondition for price stability.

In the United States, the Federal Reserve (Fed), having met its inflation target and given the robust recovery of the labour market, started tapering its asset purchases in November. Moreover, it announced an acceleration of the rate hike at its last meeting of the year and went on to forecast three rate hikes in 2022 and a total of eight by the end of 2024. All this in a context in which the Fed stopped describing inflation as a "transitory" phenomenon.
In the United Kingdom, the Bank of England (BoE) raised its benchmark interest rate in December by 15 basis points to 0.25%, in response to a significant increase in inflation and a tightening labour market. In addition, the BoE completed the implementation of its asset purchase programme in December. Finally, it announced that it will stop reinvesting the maturities of its asset programme when the policy rate reaches 0.50% and that it will start active sales when the policy rate reaches 1.00%.

In emerging countries, rate increases were aggressive and widespread, at rates of more than 100 basis points in some countries. This was a response to the increase in inflation and fears of a de-anchoring of inflation expectations. In the case of Mexico, the central bank raised the official rate by 150 basis points in total, accelerating the pace of hikes in the final part of the year to 5.50%. In some countries (e.g., Chile, Brazil), official rates ended the year clearly above pre-COVID levels. The main exceptions to this policy were China, where the authorities adopted a laxer tone in the face of the economic downturn, and Turkey, where the central bank cut the policy rate, ignoring rising inflation.

Financial markets

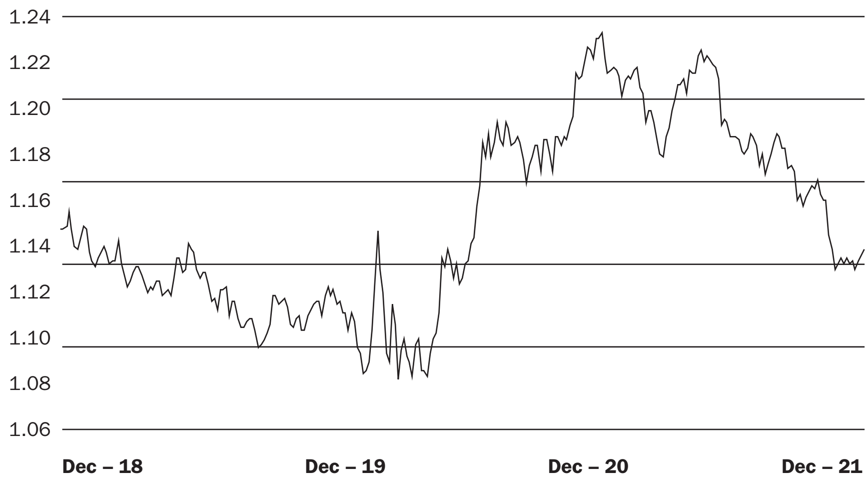
Global financial markets have continued to be supported by the economic measures implemented by the various authorities following the outbreak of the COVID-19 crisis, the implementation of the vaccination process and the economic recovery. Against this backdrop of lax financial conditions and increased pandemic control, risk assets generally performed well, and corporate spreads closed the year at levels close to or below those prior to the outbreak of the COVID-19 crisis. On the negative side, some Asian markets stood out in the face of increased regulatory scrutiny of some sectors by the Chinese authorities and problems in the Chinese real estate sector. Moreover, some vulnerabilities of capital markets were highlighted, such as reduced liquidity and depth in some markets at times of heightened uncertainty or excessive risk-taking, as evidenced, for example, by a high use of derivatives by retail investors.

Long-term government bonds in major developed countries experienced significant increases in 2021 (78 basis points in the UK, 60 basis points in the US and 39 basis points in Germany) on the back of the vaccination process, a higher inflation environment, central banks' pivoting and market recalibration of expectations of official interest rate hikes. Uncertainty caused by variants of the delta and omicron viruses and problems in China's real estate sector put a brake on the upward movement in profitability. Interest rates ended the year at levels still low by historical standards (1.51% in the US, -0.18% in Germany and 0.97% in the UK).

Periphery sovereign risk premiums ended 2021 at somewhat higher levels than the previous year, as the market recalibrated on future rate hikes by the ECB and the confirmation that the PEPP will end in March 2022. In any case, they remained at contained levels, supported by the ECB's asset purchases, the launch of the NGEU, the arrival of Mr Draghi in the Italian government and the upgrades to Italy's debt rating.

G4 Spanish 10-year government bonds. In %. *Source*: Bloomberg.

With regard to the currencies of developed countries, the dollar was particularly strong, appreciating by almost 7% against the euro. This occurred against a backdrop of uneven and mismatched economic recovery due to vaccine shortages and the reduced capacity of emerging countries to procure vaccines. In addition, the new COVID-19 variants continued to raise fears in the markets about the impact they could have on the economic recovery. Finally, and especially from the summer onwards, the dollar was supported by the Fed's less accommodative tone and the prospect of greater divergence of its monetary policy compared to that of the ECB. The GBP, in its cross against the euro, appreciated by almost 6%. The rapid progress of the British vaccination programme, as well as the attitude and actions of the BoE, contributed to this. Tensions over Brexit and the Northern Ireland protocol possibly prevented further appreciation.



G5 USD/EUR.
Source: Bloomberg.

Equity markets in developed countries performed positively, supported by accommodative central banks and the economic recovery. Most European and US stock market indices ended the year with gains of between 15% and 30%, in many cases reaching new all-time highs. Despite widespread gains in the main indices, sectoral differentiation continued to exist, with those most affected by the pandemic performing even worse in relative terms. The IBEX 35 lagged behind, rising only 8% and still trading at levels below pre-pandemic levels.

In financial markets of emerging countries, sovereign risk premia moved upwards, especially in the last part of the year, in a context in which the relative position of these economies was evidenced by their weaker relative position: (i) the reduced control of the pandemic; (ii) aggressive interest rate hikes, which may threaten the incipient economic recovery; (iii) economic and financial weaknesses in China; and (iv) fiscal and/or financial vulnerabilities in emerging countries such as Brazil or Turkey. In addition, profitability on domestic debt rebounded and, with the exception of the yuan, currencies tended to depreciate, most notably the Turkish lira, which lost more than 40% of its value against the dollar.

Banking sector environment

Banking sector

The global banking sector has proved resilient to the COVID-19 crisis. Banks have remained well capitalised after the pandemic in aggregate terms. In major developed economies, the CET1 capital ratio would, according to the authorities, remain above the regulatory minimums, even in an adverse scenario. The favourable solvency situation and the reduced uncertainty regarding COVID-19 have led the Fed, the ECB and the BoE to allow banks to pay dividends and buy back shares again, after not being allowed to do so after the outbreak of the pandemic. The profitability of the banking sector has recovered to pre-pandemic levels, although it has remained at structurally low levels. In terms of liquidity, the TLTRO III have provided important support and have contributed to supporting lending to the real economy.

In this crisis, NPLs have not behaved as usual in a recessionary cycle, thanks, among other things, to the swift and decisive response of economic policy. The aggregate NPA ratio in the Eurozone declined in the first half of the year to 2.4% and the inflow of loans on special surveillance (stage 2) has been moderate during the year. Despite the resilience of asset quality, the sectors most affected by the pandemic, such as accommodation and catering and leisure, have seen the most significant deterioration. On the other hand, the pace of provisioning has moderated after the effort made in 2020, although the authorities have continued to advise caution. In any case, the release of provisions has been heterogeneous across countries and institutions, with Spanish, Italian and French banks being the most cautious. The impact in terms of non-performing loans with moratoriums or public guarantees has been limited.

Regarding the Spanish banking sector, the Bank of Spain (BdE) has pointed out that the pandemic has confirmed the need to address the sector's structural challenges: (i) the generation of profitable turnover in a

The global banking sector has proved resilient to the COVID-19 crisis and has been recovering gradually in 2021.

low interest rate environment; (ii) increasing competition from technology companies; (iii) increasing cyber risks; and (iv) potential negative effects associated with climate risks.

Financial stability and macroprudential policy

Over the course of 2021, financial authorities have stated that global financial stability risks have been diminishing thanks to the economic recovery. In any case, they argue that these risks remain elevated and centred on the incomplete recovery of some sectors, the persistence of global bottlenecks, an increase in inflation, high public and private debt levels, tight asset valuations and increased risk-taking by the non-bank financial sector.

The COVID-19 crisis has shown that the significant growth of the non-bank financial sector in recent years and the absence of regulation have led to a build-up of vulnerabilities in this sector. These structural vulnerabilities and the interconnections between the non-bank financial sector and the banking sector pose a risk to financial stability. This has led the main global and European regulatory authorities to focus during 2021 on developing the regulatory and macroprudential framework for the non-bank financial sector, focusing on liquidity, maturity, leverage and risk management duration.

In Europe, the authorities have begun to voice their concern about the dynamism of the real estate market in some countries. In the residential segment, this concern has been focused on countries with pre-pandemic vulnerabilities in that sector (e.g., Germany), and in the commercial segment the focus has been on the lack of recovery of lower quality assets. In this context, the ECB has recommended that national authorities adopt macro-prudential policies in the real estate sector. The Bank of England, meanwhile, has indicated that it will evaluate the possible withdrawal of one of the restrictive measures on mortgage loans in place since 2014.

COVID-19 has been a challenge for macro-prudential policy, which has also complemented fiscal and monetary policies. Once the outlook for economic recovery has turned favourable, several European macroprudential authorities have signalled their intention to start rebuilding the released capital buffers. The Bank of England has confirmed that it will increase the counter-cyclical capital buffer (CCyB) from 0% to 1% by the end of 2022, to provide room for manoeuvre in case downside risks crystallise and the economy needs support from the financial sector. In France, the financial stability authority has indicated that normalisation of the CCyB could start soon, while in Spain it has remained at 0%, because the BdE considers that cyclical systemic vulnerabilities are not increasing.

Still in Spain, the BdE has developed three new macroprudential tools for credit institutions aimed at mitigating systemic risk, which can be activated as of 2022: (i) sectoral component of the counter-cyclical capital buffer; (ii) sectoral concentration limits; and (iii) lending limits and conditions.

Banking Union and Capital Markets Union

Progress in terms of European integration has been limited in 2021, in a context of an election year in Germany. However, the new German government has been more open to moving forward with the completion of the Banking Union and the Capital Markets Union (CMU).

Access to European primary capital markets continued to expand in the first half of 2021, although the securitisation market has shrunk over the past three years. In parallel, the EC has adopted a legislative package including measures in the context of the CMU action plan presented in 2020. The main objectives are to improve access to finance for SMEs, expand investment opportunities for retail investors and enhance capital market integration.

Regulatory environment and supervision

In the second year of COVID-19, the authorities have been returning to regulatory and supervisory normality. Highlights include: (i) the start of the process, in October, for the transposition of Basel III into European regulation; (ii) the end of restrictions on the distribution of dividends and share buybacks by banks in the main developed economies; and (iii) the return to stress testing of the banking sector.

The authorities and the industry have been engaged throughout 2021 in ensuring that the transition of benchmark indices, following the cessation of publication of much of Libor and Eonia on 31 December, would not cause disruption in financial markets. In addition, it has been confirmed that the Libor benchmark administrator is to publish in 2022 the 1, 3 and 6-month sterling and Japanese yen Libor with synthetic methodology based on

F&O risk-free rates. These six Libor adjustments will only be available for use in some existing (legacy) contracts and not for use in new contracts.

Brexit

On Brexit, limited progress has been made following the signing of the MoU (Memorandum of Understanding) in early 2021. The EU has maintained a position that equivalence in financial regulation will be maintained, while the UK has assumed that there will be no more ambitious deal and has begun to look at the possible review of its regulation, as well as increasing the focus on becoming a green and digital hub.

Challenges for the banking sector

In terms of sustainability, both market and regulatory scrutiny of the banking sector's incorporation of climate risks has continued to increase. At the same time, the development of the sustainable finance regulatory framework has continued, with a focus, for the time being, on disclosure. Thus, the financial sector will have to deal with the implementation of a significant amount of new regulation related to sustainable finance in the coming years. The adoption of the taxonomy of environmentally sustainable activities was an important milestone for the EU in 2021, as will be the completion of the ECB's climate stress test in 2022. With regard to Spain, the approval of the Climate Change and Energy Transition Law has reinforced the country's decarbonisation strategy and increased climate information requirements for the financial sector.

The pandemic has accelerated the processes of digitalisation, giving rise to several focus points. On the one hand, the entry of Bigtech into financial services is leading the banking sector to insist on regulation according to the principle of "same activity, same risk, same regulation". For their part, there is a widespread view that crypto-asset technologies have great disruptive potential and that, although they do not pose a systemic risk for the time being, their rapid growth means that efforts to regulate them need to be accelerated. Finally, authorities and the financial industry have warned that cyber-attacks have increased in both frequency and sophistication as a consequence of increasing digitalisation.

Outlook for 2022

Favourable global economic developments are to be expected in 2022 in a context where COVID-19 should continue to lose its centrality as a determining factor for economic activity and financial markets.

Inflation could remain elevated in the coming months, influenced by aspects such as the remaining disruptions in global production chains and energy prices. Greater control of the pandemic should alleviate some of the inflationary pressures.

In policy terms, central banks can be expected to move forward with their exit strategy. The Fed is expected to implement several rates hikes this year, while the ECB may wait a little longer.

Regarding financial markets, relatively loose financial conditions are expected to prevail. In any case, there may be occasional bouts of volatility in the face of upside risks to inflation and central banks' pivoting.

In Spain, the economy is also expected to perform well on the back of the progressive control of the pandemic, the use of European NGEU funds and a still low interest rate environment.

Within the financial environment, progress is expected on the global regulatory framework for crypto-asset-related activities.