PRESENTATION OF THE ANNUAL REPORT

2010

Governor's address to the Governing Council of the Banco de España

BANCO DE ESPAÑA
Eurosistema

ADDRESS TO THE GOVERNING COUNCIL OF THE BANCO DE ESPAÑA ON THE PRESENTATION OF THE *ANNUAL REPORT*

Miguel Fernández Ordóñez
GOVERNOR

Depósito legal: M. 25496-2011
Imprenta del Banco de España

ADDRESS TO THE GOVERNING COUNCIL OF THE BANCO DE ESPAÑA ON THE PRESENTATION OF THE *ANNUAL REPORT*

Around this time a year ago, I began my presentation of the *Annual Report* for 2009 highlighting the complexity of the economic situation in Europe in general, and in Spain in particular. The EU Heads of State and Government had just approved the programme of financial assistance to Greece and the first steps of a far-reaching reform of the European system of governance were becoming discernible. Spanish economic policy had taken a turn in the right direction, focusing on fiscal consolidation, completing the restructuring of the financial system and implementing supply-side structural policies, as the headroom for demand-boosting policies had been fully exhausted. Looking at what has happened since, as the *Annual Report* for 2010 before us does, the progress in the processes undertaken back then is significant, although the situation remains very complex in both Europe and Spain.

Over the course of last year the ongoing recovery in the world economy firmed, reaching a growth rate of 5%. Europe, and in particular the euro area, were also part of this firming in growth, though the increase in GDP was rather more modest: 1.7% in the euro area as a whole, and with notable differences across the Member States. In Spain, following the serious recession the previous year, a very weak recovery began in 2010 against an external background dominated by the tensions on European debt markets, which have further compounded what are already complex and demanding internal constraints.

The sovereign debt crisis is the most serious shock since the founding of the single currency, and a first-order challenge for the European authorities and for the Member State governments. When the Greek fiscal crisis broke in May last year and the difficulties rapidly spread to the area as a whole, it became clear there were serious shortcomings in the institutional framework of the euro. The problems were manifest in three main areas: the limited capability of the Stability and Growth Pact and of national fiscal frameworks to ensure the operation of fiscal policies in keeping with the requirements stemming from membership of a monetary union; the absence of effective consultation, coordination and multilateral surveillance mechanisms to identify and pre-empt the build-up of macroeconomic imbalances in other areas; and finally, the lack of the necessary tools and procedures to manage and resolve crisis situations which, like those first in Greece, and later in Ireland and Portugal, have serious repercussions for stability in the area as a whole.

In recent months there has been significant progress on three fronts. Once the European Parliament has passed the legislative initiatives currently in train, the European Union will have emerged from this process with a new and strengthened Stability and Growth Pact – one more heedful than in the past to the behaviour of public debt and that operates with greater automaticity – and with revised and improved national fiscal frameworks. Europe will also have a new and effective early-warning system to correct other potential non-fiscal macroeconomic imbalances, and a permanent crisis-management mechanism, the so-called European Stability Mechanism.

Hopefully, once the reform of governance is complete, the European Union will have powerful mechanisms for effectively preventing and resolving episodes of crisis such as the present one. In the short run, however, the situation of the Irish, Portuguese and, above all, Greek economies poses pressing problems. The transition to the new governance framework is taking place amid the episode of most tension the euro has undergone in its short history. It would be a serious mistake to underestimate the risks this involves. If the current problems are not resolved, the efforts to re-design the institutional framework of the euro may have been in vain.

In critical situations like the present, which have to a greater or lesser extent marked the construction of the common European project, it is important to keep some historical perspective. The overcoming of difficulties has always been thanks to drive, collaboration and the vision of those responsible for taking hard decisions. If this pattern continues, European leaders will prove capable of appreciating the enormous benefits to be had for all member countries from the high degree of economic and financial integration attained within the European Union and, particularly, the euro area, and they will sideline the short-sightedness and short-termism that might trigger backsliding of unforeseeable consequences.

The Spanish economy is in no way detached from this trajectory of the European project which binds the future of each of the participating economies to a common destiny. Indeed, it was affected particularly harshly during the episodes of the sovereign debt crisis in Greece and Ireland, though not so much in April this year, when Portugal applied for financial assistance and Spain was seen as more akin to economies such as Italy and Belgium. In any event, difficulties have persisted over the past year, ups and downs have been the norm and sovereign risk premiums have held at excessively high levels.

The caution shown by investors reflects the combination of euro area instability with the factors of vulnerability weighing on the Spanish economy as a result of the imbalances that built up during the long upturn and of others that emerged during the crisis.

The source and growth of the imbalances generated during the long expansionary phase have been more than sufficiently chronicled. We need only recall here how the supply-side response was unable to counter strong demand pressures, fuelled by the fall in interest rates, the rapid growth in credit and the rise in real estate asset prices, and how persistently excessive demand and all its consequences ultimately ran down the pace and pattern of growth followed until then, giving rise to a complex and inevitably costly adjustment.

Highly accommodative monetary and financial conditions proved to be a suitable breeding ground for macroeconomic and financial imbalances that fed off one another. On one hand, the real estate over-expansion, based on the abundant financing of development activities, prompted rapid private-sector indebtedness and, as a counterpart to this, the over-sizing of the financial system and growing resort to international wholesale markets in search of funding. On the other, the continuous increase in relative costs and prices over more than a decade engendered a problem of competitiveness that contributed to shifting expenditure to the external sector. The resulting notable dependence on external financing would be a further factor leaving the Spanish economy exposed to episodes of nervousness on international financial markets further to the sovereign debt crisis.

The recession added further difficulties. First, job destruction was intense owing to the institutional particularities of our labour market, whose deficient working made the weight of the adjustments fall excessively on employment. This onerous shortcoming calls into question, among other things, the capacity to absorb the surplus employment generated by the real estate crisis, to restore long-term growth potential and to ensure the sustainability of public finances, which I shall now discuss.

The intensity of the contraction in domestic spending and the labour market deterioration significantly impacted public finances. Despite a favourable starting position – a surplus of close to 3% of GDP and public debt of 36% of GDP in 2007 – the general government deficit increased during the crisis, rising to 11.1% of GDP in 2009, and the public debt ratio climbed by around 17 pp to 53.3% of GDP that same year, although still below the average for Europe and for the countries that the sovereign debt crisis would ultimately most impact. Beyond the factors that prompted such a speedy and large-scale deterioration in the fiscal position, which are addressed in detail in the *Annual Report*, it is telling that this development came about at a time when the markets were precisely scrutinising the emergence of any potential problem for public finances sustainability. Accordingly, this decisively influenced the financial tensions looming over the Spanish economy. In this climate of scrutiny, the comparatively low level of public debt was not as important as the speed at which it was deteriorating and the potential consequences of the high levels of private-sector debt, of the need for balance-sheet write-downs in the financial sector and of the difficulties preventing the economy growing at a sufficiently high rate. In fact, the unfolding of the crisis has once again highlighted how excess debt, irrespective of whether it is general government- or private-sector-related, tends to adversely affect the perception of fiscal sustainability.

The crisis also ultimately affected the Spanish financial system which, though it had weathered the international financial crisis without excessive difficulties, was subject to greater pressure when all the components proper to the macroeconomic crisis emerged. The rise in bad debts – especially in the real estate development sector, where a substantial portion of lending had been concentrated – and the tightening of funding conditions on the wholesale financial markets that accompanied the diminished confidence of investors in the Spanish economy proved particularly demanding for some banks, mainly savings banks. And while the difficulties were confined to a limited segment of the sector, at the peak of the crisis market pressures spread to the system as a whole, irrespective of the particular situation of each institution.

As a result of all these factors, when the sovereign debt crisis broke in Europe, the Spanish economy was highly exposed to financial instability contagion. At that point it was vital to shift the economic policy stance so as to restore confidence and counter the speculation triggered as a result of the mechanistic extrapolation of the negative experiences of other countries with serious vulnerabilities. The responsiveness of economic policy and the perception of its firmness were the sole barriers that could prevent indiscriminate mistrust taking hold.

Firstly, and given the source of the tensions, it was of pressing concern to dispel doubts about public finances. To this end, a demanding fiscal consolidation plan was approved in May last year. It brought forward the bulk of the adjustment to be made by 2013 to 2010 and 2011, and it decisively targeted the structural component of the deficit and, hereunder, mainly public spending. In parallel, there was an urgent need to tackle the shortcomings of the labour market, which were blocking the absorption of unemployment and the adjustment of the economy. A labour market reform was duly embarked upon, initially excluding the collective bargaining system. On the financial front, greater speed was applied to the restructuring that had begun a year earlier, overhauling the savings bank sector.

All these developments affected the Spanish economy, which moved onto an as-yet very weak path of recovery in the first half of 2010, and which has run into the opening months of the current year. In parallel, the correction of the accumulated imbalances continued at a reasonable pace. The adjustment of the real estate investment excess continued, with further cuts in activity in the sector and in house prices. The net borrowing of the nation also declined, albeit at an increasingly moderate rate owing to the adverse impact of the rise in oil prices on the trade balance. Lastly, core inflation remained moderate, if the effect of the rise in indirect taxation from 1 July is stripped out. In contrast, the overall price index climbed sharply in the second half of 2010 and opening months of 2011, driven by rising commodities prices and by the changes to regulated prices. Given the temporary nature of many of these impulses, this pattern should be reversed in the coming months if the second-round effects are curbed. This is a vital condition for the necessary improvement in competitiveness to come about and for heading off the damage that a lasting increase in the inflation rate would inflict upon constrained household spending capacity.

The ongoing restructuring of the non-financial private sector, which needs to reduce its debt levels to resume any buoyancy in spending, is apparent in the slight reduction in the outstanding balance of credit to households and firms, which is contracting at an annual rate of 1% and 2%, respectively. In the case of firms, the pattern differs across productive sectors: loans to the most indebted companies, as is the case in real estate development, are falling at a higher rate (of around 3% in 2011 Q1), while the bulk of Spanish household debt is in long-dated mortgage loans with pre-set repayment terms, meaning that the volume of this debt is hardly likely to fall swiftly in a climate like the present. The financial tensions have made for tighter lending standards, which have become more prevalent with the worsening of the sovereign debt crisis and which are affecting to a greater extent those sectors finding it hardest to demonstrate their ability to pay in the current adverse conditions.

It is essential that the ongoing re-balancing of the Spanish economy should move promptly forward so as to restore greater dynamism in the medium term. Inevitably, however, the adjustment will constrain the intensity of the recovery in the short run. In 2010 and in 2011 to date, the withdrawal of the expansionary fiscal impulses and their replacement with a firm consolidation programme, the correction in the construction sector and the financial restructuring needs of households and firms should naturally have limited the possibilities of reinvigorating spending, and this will foreseeably continue to be the case in the coming quarters. Fortunately, these contractionary effects are being offset by the momentum of exports, which must act as the prime driver of activity and income. It will be pivotal here to attain additional gains in competitiveness which, indeed, is the main variable the economy can draw on to overcome the current difficult circumstances.

Once this phase is over, restoring order to the financial position of households and firms will mean that consumption and business investment are better placed to hold sustainably on a more dynamic course. In turn, fulfilling the goals of the fiscal consolidation programme will contribute to dispelling doubts over the sustainability of our public finances. And foreseeably, this will see the normalisation of lending conditions, which should benefit too from the completion of the restructuring of the financial system.

But for this scenario to take hold, the obstacles still hampering recovery must be overcome. How the sovereign debt crisis unfolds will be a major determinant, and this is something beyond the control of Spanish economic policy. But the role of our economic policy remains fundamental, whatever the scenario, for overcoming the inefficiencies that have been highlighted and for lessening the mistrust that hinders and raises the cost of the vital foreign funding needed to keep the Spanish economy safe from any incident that might occur in the European arena.

The fiscal consolidation begun last year has started to bear fruit, although the effort required ahead is considerable and great determination will be needed in defining and specifying the necessary measures. In 2010, the general government deficit declined by almost 2 pp, standing slightly above its projected level (9.2% of GDP). Nonetheless, the intensity of the adjustment and compliance with objectives were uneven across the different tiers of government. The greatest progress was at the central government level. Conversely, the regional government deficit rose slightly, set against its projected decline, and there were minor deviations from budget in local government and in the Social Security System.

Meeting the fiscal targets in 2011 will entail a further reduction of 3 pp in the general government deficit. This must mainly stem from the structural component, as was the case last year. Considerable effort will be involved, both from the standpoint of the size of the cut and of the inertia that some spending items have traditionally shown. In the current circumstances, strict adherence to the plans announced is essential. A watchful, pre-emptive stance is needed to prevent possible overruns from materialising and, should they do so, the necessary measures must be launched immediately to correct them, as the government has undertaken to do.

All the fiscal discipline mechanisms available within our budgetary framework must be used to correct the deviations that might arise. Such is the case of the strict application, across the board, of the system for authorising regional government debt, whereby authorisation is conditional upon meeting deficit targets and upon the approval of re-balancing plans in the event of deviations.

There is also a case for exploring the application in Spain of some of the ideas being voiced in the European debate on the most effective budgetary frameworks for ensuring fiscal discipline. Specifically, the budgetary frameworks combining budget deficit rules with specific spending ceilings appear to offer the best results, as they enable measures to be applied to the main sources of budget deficits and oblige surplus takings due to cyclical reasons to be allocated to improving the fiscal position. Along these lines, the government has announced its intent to include a rule in the Budgetary Stability Law whereby general government spending may not exceed the benchmark medium-term growth rate of the Spanish economy. This will be immediately applicable to central and local government, and its adoption by the regional governments will be pursued. A fiscal rule of this nature applied to the general government sector as a whole in the years prior to the financial crisis, when the growth rate of tax revenue was very high but largely temporary due to its links to the real estate boom, would have provided for far-reaching improvements in the underlying fiscal position and would have averted the risk of overestimating the spending headroom available. To maximise its effectiveness, application to all levels of government should be ensured and the mechanism for correcting potential deviations should be made explicit.

Transparency must also be reinforced, in particular by increasing information on the budget outturn of the different tiers of government. In this connection I favourably view the significant progress since late last year in the disclosure of regional government budget outturn data. The absence of these figures was a historical shortcoming that had proven particularly hazardous at times in which a lack of information could result in a lack of market confidence. Access to such information partially redresses this dearth. But to fully dispel doubts over the state of regional finances, further steps are needed. Specifically, the regular publication of overall and individual regional government figures offering the same periodicity, degree of detail, time-lag and ease of access as central government data would be desirable.

In sum, to head off the risk of the fiscal consolidation path not being adhered to, all levels of government must be involved in the adjustment. It is also equally important to reiterate the institutional commitment to budgetary stability, reinforce the rule-enforcement mechanisms, increase the transparency of public finances and strengthen medium-term budgetary planning.

Fiscal consolidation must, moreover, be accompanied by an ambitious programme of structural reforms in this area geared to improving employment generation and growth capacity. This is not only because in the short run it is vital to reinvigorate the growth of taxable income and to reduce the spending components most linked to the cycle. It is also, above all, because in the medium term public finances will face major challenges, chiefly the need to finance the growth in public spending that population ageing will involve. A problem on such a scale may be controversial, but it will no doubt emerge in Spain at a time in the future which is ever closer, as it has begun to do already in other developed countries.

I therefore consider that the government's proposed reform of the pensions system presented in January this year is a crucial step towards ensuring the sustainability of our public finances, and there should be no delay in legislating for this with all due precision as far as the sustainability factor is concerned. It is an example of measures that harness the complementarity between public finances sustainability and the setting in place of structural conditions on the supply side, and this is how the markets have understood it.

As regards financial system restructuring, an important regulatory step was taken back in 2009 with the creation of the Fund for the Orderly Restructuring of the Banking System (FROB). Culminating this was the reform of the legal regime governing savings banks last year, and the enactment in February this year of Royal Decree-Law 2/2011, which has speeded restructuring as well as requiring higher levels of top-quality capital.

Since the process began, headway has been made in the different areas encompassing the strategy to transform our banking sector. Indeed, since January 2008 banks have recognised and assumed asset impairment losses totalling €96 billion, which is equivalent to 9% of GDP. The highly fragmented savings bank sector has seen a reduction in its numbers from 45 to 18, by means of integration processes accompanied by plans to reduce capacity, necessitating cuts in the number of offices, employees and other operating expenses. The new requirement for greater regulatory capital obliges all Spanish institutions to operate with a higher level of capital and encourages them to tap the markets in this connection, either through initial public offerings or through the entry of private investors. Finally, the virtual conversion of savings banks into banks has been carried out, even in the case of those institutions which, pursuant to Royal Decree-Law 2/2011, did not need to increase their core capital.

A key instrument for accelerating reform in the sector has been transparency. Spain published the stress tests of all savings banks and listed banks, something – as is known – which no other European country did. Analysts and media throughout the world have the necessary information to assess the situation of small Spanish banks, something it is not possible to do in other countries. Further, all institutions have been obliged to publish in great detail their exposures to the most troubled assets, along with the main outline of their financing and debt maturity structure. Finally, and unlike standard practice in other countries, the methodologies for provision-measurement and provisioning requirements are public.

Transparency has disadvantages in the short run, since nobody can talk about what is not known, whereas when information is provided, everybody's attention is drawn. Yet transparency has proven to be a most useful tool for this reform, as it has enabled public opinion to understand the need to transform the sector, it helps dispel doubts about the soundness of the Spanish banking sector, and it is encouraging managers and the authorities to undertake restructuring without delay.

The recapitalisation of savings banks is moving at a relatively measured pace. This is because the strategy followed in Spain has not been confined to mere recapitalisation through the injection of taxpayers' funds; rather, a far-reaching and lasting transformation of the sector has been proposed. Moreover, savings banks have been accorded the possibility of designing and voluntarily carrying out such restructuring. As a result, they will only be assigned to other institutions through competitive procedures if their plans are not viable or are not adhered to. Finally, the fact priority has been given to private initiatives inevitably takes up more time than nationalisation, the vehicle used in other countries. But it should yield significant advantages in the medium and long run, in terms of the cost for taxpayers and, above all, of the soundness and durability of the new projects.

That said, the process is moving forward in accordance with the terms and schedule laid down in Royal Decree-Law 2/2011. On 11 March, the Banco de España published the capital requirements for all institutions. After one of the integration projects was called off, a total number of 13 institutions need to increase their capital. On 14 April, the Banco de España approved the strategies and timetables submitted by these institutions. Two of them were subsidiary banks of foreign institutions that are being recapitalised by their parents. Another two Spanish banks bolstered their capital resorting to the market. Of the remaining institutions (nine savings banks or groups thereof), four set their priority to raise capital tapping the market, with the FROB acting as a subsidiary alternative. Another savings bank of the nine mentioned stated its preference to participate in an integration process with another more capitalised institution. Finally, the remaining savings banks have declared their preferred option to be to raise capital by resorting to the FROB.

The institutions that have opted to tap the market, either through an initial public offering or taking on board private investors, are now at the search, negotiation and valuation stage associated with this strategy. For the savings banks that have requested FROB participation in their capital, business and recapitalisation plans are being analysed, and the valuation of the institutions by independent experts has also begun. Given the progress made, and if the established timetable is followed, the new landscape should be sufficiently clear by 30 September this year, without prejudice to the extensions provided for in the Decree.

The Banco de España considers that the capital requirements under Royal Decree-Law 2/2011 are sufficient to ensure the soundness of the Spanish banking system, not only under the most likely macroeconomic scenario, but also in stressed scenarios highly unlikely to occur. As is known, some analysts considered that capital needs might be greater in the future. Were this the case, i.e. if the stress tests evidenced additional capital needs and these were not covered by either the banks or the market, the FROB would provide the extra funds required under such stress tests, as provided for in the Royal Decree. In any event, even the most pessimistic forecasts on the future of the Spanish economy point to a need for public funds that would entail only a modest rise in Spanish public debt.

Finally, improving the working of the labour market remains the most necessary and pressing economic policy task. As I have stressed on countless occasions, it is vital to draw our institutional and legal framework closer to the models of the other developed countries, combining the obligatory employee protection with flexibility that helps improve the capacity to reallocate jobs across companies and sectors. Within the euro area, this task has become urgent in order to entrench the recovery in the short term and to raise long-term growth and productivity prospects. In the absence of the devaluation option, only far-reaching reform in this field will provide for a prompt recovery in competitiveness without having to pay the steep social costs of letting the mere passage of time generate the productivity gains needed.

Last Friday the government approved a Decree-Law containing some improvement to the regulation of collective bargaining. However, in its passage through Parliament, headway is expected to be made, above all, in allowing workers and employers to decide what they believe is advisable for improving the productivity and competitiveness of their companies, since without this an excessively high price in terms of unemployment and low growth will continue to be exacted of our economy over a long period. And, naturally, to boost and accelerate the effects of this important reform of the institutional employment framework, it should also be accompanied by a heightening of competition in the markets for goods and services.

In short, we are at a crucial juncture where achieving the right monetary and fiscal stance and successfully managing economic policy will be pivotal for the future of the Spanish economy. Approving and properly implementing policy will, moreover, be the best Spain can do to help resolve the euro crisis. If the other European countries can stand above the fray and show vision in tackling the problems threatening stability in the euro area, at our meeting next year to present the *Annual Report* the economic outlook for Spain and Europe may be much more benign and prosperous than that we can discern today, amid the crisis.

Let me conclude by thanking all the Bank’s staff and its governing bodies for the drive and dedication they have shown in the tasks our country has entrusted to us.