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

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

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## Address to the Governing Council of the Banco de España on the presentation of the *Annual Report*

Ladies and gentlemen,

In 2006 the behaviour of the world economy and of the European economy in particular provided a highly favourable setting for the continuation of the Spanish economy's 13-year-long expansion. The world economy grew by 5.4% last year, up even on the high rates of the previous two years, this being the most dynamic three-year period of growth for more than 30 years. The strong increase in oil prices in the first half of the year and the less expansionary stance of macroeconomic policies did not check this dynamism, which was moreover compatible with the containment of inflation rates worldwide and with a more favourable financial market performance.

The geographical distribution of growth was more balanced and more favourable for the Spanish economy. The notable recovery in the euro area, along with economic firming in Japan, offset the slowdown in the United States. The contribution of the emerging economies to the global expansion, with China and India to the fore with growth of around 10%, remained a key factor. Latin America also grew satisfactorily and its inflation fell to all-time lows, against a backdrop of generally prudent macroeconomic policies which have contributed to a further reduction in the region's financial vulnerability. However, the meagre progress in structural reforms and the unorthodox direction taken by some countries' economic policies may curtail future growth possibilities.

In the short run the world economy can be expected to continue posting high growth, unless the US slowdown becomes more acute and the rest of the world is unable to continue growing under its own steam. Further ahead, the continuity of the high rate of expansion of the world economy is more uncertain. The increased efficiency and productivity gains brought about by globalisation, through greater trade integration and a far-reaching reallocation of resources and factors, might begin to weaken. In this setting, the emergence of protectionist tendencies – such as those manifest in the difficulties of moving the Doha round forward – is an added risk to continuing high growth.

Inflation has remained contained worldwide. The growing integration of the emerging economies into the global economy, providing abundant low-cost labour, coupled with heightened competition on world markets and technological innovation have allowed price increases to moderate significantly. The anchoring of inflation expectations, to which the credibility acquired by central banks in their efforts to preserve price stability has contributed, and the headway in the programmes for structural reform and increased flexibility in economies have likewise eased inflationary pressures.

All these developments have helped contain the upward pressures stemming from the impulse of domestic demand and have made the task of monetary policies easier. In 2006, as the strength of economic growth progressively alerted to the emergence of inflationary pressures, the monetary policy stance became less expansionary in virtually all economies, developed and emerging alike, and inflation rates held at low levels overall, without any substantial pass-through of higher energy prices to core inflation being discernible.

Yet the reduction in spare capacity and labour market tightening will heighten inflationary pressures in many economies, and further oil price rises cannot be ruled out. Moreover, as the business cycle matures, the task of monetary policymakers may become more difficult, espe-

cially for certain central banks like the Federal Reserve which will have to square inflationary risks with those stemming from the economic slowdown.

### **The euro area**

As already stated, the euro area economy finally managed to emerge from the phase of low growth experienced in recent years. GDP for the area grew at a rate of 2.9% in 2006, almost double that of the previous year and the highest rate since 2000. For the year as a whole, inflation, measured by the rate of increase of the HICP, stood as in 2005 at 2.2%, much influenced over the course of the year by oil price movements. Core inflation moved mildly upwards during the year, perhaps reflecting some minor indirect effect of the rise in energy prices against a background of strengthening activity and employment. Nonetheless, there has been notable wage moderation so far, perhaps in response to greater labour market flexibility and growing competitive pressures worldwide. But it remains to be seen how wages will react in the face of more buoyant domestic demand.

Throughout 2006 the stance of demand-side policies was consistent with the pick-up in private agents' spending. However, in the monetary policy realm, the strength of the recovery warranted a gradual adjustment in monetary conditions by the European Central Bank. Following the rise in official interest rates in December 2005, the ECB continued in 2006 progressively to withdraw the stimulus provided in recent years in the light of the observed risks to price stability in the medium term.

Turning to budgetary policies, the improvement in the business cycle contributed decisively to tax revenue growing substantially above forecast in 2006 and to the euro area budget deficit declining by almost 1 pp. Given the persistence of high deficits in many countries, it is of paramount importance to harness the opportunity provided by the current boom to complete the ongoing restructuring of public finances and to push through measures to boost productivity and employment generation.

Precisely in this latter area, the year 2006 saw progress – albeit uneven across countries and economic policy areas – in the application of the structural reform agenda. Undoubtedly, the favourable performance in 2006 in terms of employment and growth in activity is largely the result of the course of the business cycle. But it seems likely there are also incipient positive effects stemming from the structural reforms already implemented, which may be responsible for the high rate of job creation in this phase of the recovery and the rise in productivity. That would show how efforts to heighten incentives for labour market participation, to further market liberalisation and to create an environment conducive to innovation and the development of human capital ultimately bear fruit, highlighting the need for sufficient political resolve to persevere with the course of action embarked upon.

At the end of the first half of 2007, the outlook for the euro area is the brightest in recent years. For one thing, domestic demand is expected to retain its current momentum. Investment in particular should continue to benefit from the persistence of propitious financial conditions, the strength of corporate earnings and the soundness of companies' financial position, while household expenditure should continue expanding thanks to favourable employment developments. For another, exports are expected to continue faring favourably despite the likely easing in world growth. This central scenario faces the downside risk of a bigger-than-expected slowdown in the world economy. But, in contrast, a better performance of the European labour market might raise forecast growth rates.

The inflation outlook for 2007 and 2008 suggests the rate of change of the HICP will hold at around 2%, in line with the definition of price stability. However, it cannot be ruled out that the



strength of activity will lead to higher wage demands and to greater price-setting autonomy on the part of companies. Adding to these upside risks to inflation is the possibility of fresh oil price increases. In the expected setting of robust economic activity, wage moderation will remain an essential ingredient for containing inflationary expectations, which would help prolong the upturn. In the opening months of 2007, the ECB has continued closely to monitor these risks and, in general, economic developments in the area, so as to ensure that inflation expectations remain in line with the definition of medium-term price stability.

### ***The Spanish economy***

As indicated, the Spanish economy continued its long upturn last year, moving on a mildly accelerating path throughout the year. It posted a year-on-year rate of 4% in 2006 Q4, and 4.1% in Q1 this year. The buoyancy of activity is proving greater than forecast in early 2006. The recovery in the euro area has boosted exports, following their sluggishness in previous years, especially in 2005, and has supplemented the main factors that have been underpinning the expansion of the economy.

There was some re-balancing in 2006 of the relative contributions of domestic expenditure and of net exports to GDP growth, following three years of progressive divergence between these two components. Overall, the contribution of net external demand improved, despite which the net borrowing of the nation increased once more, to 7.8% of GDP. Within domestic demand, consumption slowed slightly in 2006 and construction began to show signs of decelerating in Q4, a trend that ran into early 2007. However, investment in capital goods underwent a significant increase which is holding in the year to date.

Behind these developments in the Spanish economy, along with the improved external environment, is the continuing influence of the favourable factors that have underpinned its dynamism throughout this cyclical upturn. First, there is the impulse stemming from the Spanish economy's integration into the euro area. That has been acting as a powerful spur to demand, as a result of the effects on confidence and expectations and, naturally, of the expansionary financial conditions that have continued to prevail in 2006, despite the change in the stance of the single monetary policy dating back to the closing months of the previous year. Further, there are the factors that have provided for growth on the supply side, including most particularly the growing demographic boost to the Spanish economy over the past decade, which is contributing, among many other aspects, to generating a substantial expansion in the Spanish economy's growth capacity. Finally, the importance of reform initiatives in recent decades cannot be ignored, as these have promoted market flexibility and dynamism among agents and institutions. And pivotal too have been the recent macroeconomic and financial policies, which have been a guarantee for stability.

All these factors have acted simultaneously, mutually reinforcing one another in such a way that it is difficult to assign a specific weight to any of them. Let me refer first to the demographic impulse, to which particular attention is devoted in the Annual Report presented today. Migrant flows, drawn by the substantial and constant expansion of demand, have been in turn a key factor in supply dynamics. This is because the rise in the immigrant population has increased the economy's productive capacity by means of the incorporation of abundant labour resources, while it has at the same time contributed to sustaining domestic spending growth. The Report highlights the fact that the contribution of immigration to income generation has been greater than that arising from the mere increase in population, also helping to raise per capita income. The Report also indicates that the effects on the expenditure side seem to help galvanise investment and that, in the labour market, they have introduced elements of wage flexibility and boosted mobility. Furthermore, the dynamic effects of immigration have been bolstered by the impact of the growing participation of women in the labour market.



With regard to demand-side impulses, it should be stressed that economic buoyancy has continued to be underpinned by monetary and financial conditions which, despite their gradual normalisation over the course of last year and in 2007 to date, remain loose for the Spanish economy. Although the cost of bank credit for households and firms and of fixed-income securities issues rose as the single monetary policy adopted a more neutral stance, these costs reached levels which, from a historical perspective, should be classified as moderate.

In any event, somewhat less generous financing conditions than those prevailing during the recent period of exceptionally low interest rates are better suited to the circumstances of the Spanish economy. Consequently, they provide some relief following a lengthy phase of high demand pressure, while helping to make our growth pattern healthier.

The strength of demand has been met by very favourable elements in the supply-side response. All the productive branches contributed positively to the expansion of output, though mention should be made of the continuing momentum of construction and the notable dynamism of the manufacturing branches, closely linked to the recovery in the European economies. It is worth noting once again the Spanish economy's continuing high employment-generating capacity, both in 2006 and in early 2007, since this feature is playing a key role in the continuity of this long expansionary cycle. The strong growth of employment in 2006, at a rate of more than 3% for the year on average, contributed decisively to sustaining domestic spending. And it has also enabled the growing incorporation of the population (particularly the female population) into the labour market to be compatible with further cuts in the unemployment rate, which stood at 8.5% on average in 2006, the lowest level since the late 1970s and practically on a par with the euro area average rate. The behaviour of employment denotes changes of some depth in the Spanish labour market, such as the marked fall in the structural unemployment rate, which may be interpreted as an increase in the scope available for generating employment without wage pressures arising.

The counterpart to an employment-intensive growth pattern has been modest increases in actual productivity. It is difficult to offer an accurate diagnosis of the reasons for this, given the difficulties of measuring and estimating productivity in the presence of significant structural changes, such as the composition effects arising from the concentration of growth in sectors that are relatively less dynamic productivity-wise. But what are possibly being reflected here are shortcomings in the quality of factors of production and in the characteristics of the business sector.

That said, the responsiveness of supply is not proving sufficient to counter the pressure of expenditure on price formation. On one hand, compensation per employee quickened somewhat in 2006, but to a lesser extent than did wage settlements, as a result of the changes in composition and the factors boosting labour market flexibility that I referred to earlier. On the other, in a climate of buoyant sales, the widening of business margins continued, albeit at a lesser rate than in previous years. All these factors, combined with the rise in oil prices in the first half of the year, meant that inflation rose in 2006 and that the inflation differential with the euro area stood at 1.4 pp.

Inflation began to perform more favourably in the closing months of 2006, a trend that has run into 2007, with the related differential being cut to 0.5 pp. Foreseeably, these inflation dynamics will remain in place for several months. But it should not be forgotten that the improvement has a temporary component, linked to the path of oil prices, and that core inflation remains at 2.5%, despite the continuing restraint of import prices. Price and cost increases in 2006 once again outpaced those of our competitors, prolonging the deteriorating trend of the indices that

measure relative prices and costs. Insofar as this difference is not warranted by quality improvements, the trend of these indices reflects a loss in competitiveness, whose adverse consequences for growth will become patent once domestic demand moves back onto a normal footing.

The outlook for the Spanish economy points to the continuation of the main features recently observed, namely: the restructuring of spending, thanks to a gradual easing in domestic demand, particularly in consumption and residential investment, and an improvement in the contribution of net external demand. The confirmation of these trends would allow for the projection forward of economic dynamism at somewhat more moderate rates, in line with growth potential.

For this to occur, however, further progress in slowing spending and household and corporate debt, and in improving the economy's supply-side conditions, is needed. We must not forget that the long expansionary phase of the Spanish economy has been accompanied by a build-up in certain imbalances that pose considerable risks to its sustainability. Thus, until they are sufficiently corrected, we should avoid complacency. Admittedly, recent months have seen slower growth in household debt and a gradual slowdown in house prices, while the inflation differential with the euro area has narrowed. But it is important these processes continue to head off the risks the Banco de España has been warning about.

Economic policymakers have a major responsibility to take advantage of the current economic prosperity to adopt, on a preventive basis, the measures required to harness the existing opportunities and to mitigate the risks that may arise. The change in the single monetary policy stance dating back to late 2005 has contributed to gradually normalising the financial conditions under which households and firms take their spending decisions, although monetary conditions are still accommodative for the Spanish economy.

Turning to fiscal policy, buoyant revenue, which continues systematically to grow above budget, has provided for an improvement in programmed objectives. Achieving fiscal surpluses in expansionary phases, as established under the new budgetary stability laws, not only proves suitable for easing demand pressures, but also for retaining sufficient room for manoeuvre in the face of potential deviations from the scenario of economic dynamism and, naturally, for further restructuring public finances in order to absorb the future consequences of population ageing. This is, unquestionably, the main challenge for public finances in the medium term. The agreement reached last year under the Toledo Pact also addresses the goal of ensuring the sustainability of the pensions system, although the measures adopted are still of limited scope.

It should be recalled, however, that the high growth of public revenue has a difficult-to-estimate temporary component that is linked in part to the strength of the real estate sector. Accordingly, budgetary consolidation may require an additional effort to control primary spending. The collaboration of regional and local government is vital in this connection, as they are responsible for major spending components such as public investment, health and education. This consolidation strategy should, moreover, be compatible with an improvement in the quality of public finances, since that is essential for raising incentives and for helping overcome the shortfalls in education, innovation and productivity.

But when you are part of a monetary union, the most valuable economic policy instrument is, as our own experience indicates, the deepening of reforms in order to increase the responsiveness of supply and the adaptability of the business and productive sectors to the major changes the economy is undergoing, such as globalisation and population growth.

Specifically, the dynamism and flexibility injected into the labour market by the aforementioned phenomena of immigration and growing female participation need to be accompanied by the development of a more appropriate institutional framework, without forgoing the unquestionable achievement of good industrial relations. Despite the progress achieved by labour market reforms in recent years, the need remains to better tailor collective bargaining arrangements to the different industry- and firm-level requirements and to reduce the costs associated with permanent contracts. These measures should be complemented by others aimed at improving the quality of the labour factor, by giving greater priority to educational policy in order to redress the secondary education deficit, adapt university courses to new demands and promote effective continuous training for workers.

Improving the efficiency of the economy likewise requires increasing investment in physical and technological capital, fostering innovation, pushing through privatisation where appropriate and stepping up the pace of the processes undertaken in recent years to heighten competition. The infusion of competition is particularly relevant in industries pivotal to spreading gains in efficiency to the rest of the economy, such as the network industries, the telecommunications market, the energy sector and rail transport. Some of these liberalising measures are detailed in the National Reform Programme so that, irrespective of the need to design other new measures, it would be advisable to apply this Programme more resolutely. Also, advantage should be taken of the transposition of the Services Directive to define a more straightforward and competitive regulatory framework for these activities.

Education, innovation, market liberalisation and, broadly, all reforms geared to increasing productivity are of the utmost importance looking ahead to the long term. In recent years the welfare of Spanish citizens has been increasing thanks to better use of the labour factor. This is worth celebrating since for a long time the Spanish economy's main problem was in fact a persistently high unemployment rate. But as we draw closer to success in this area (the long-term unemployment rate is now around 2%), it will be more difficult to obtain additional welfare gains as a result of increases in the employment rate. Before it is too late, we should realise that productivity is the main source of welfare in the long run, and the policies that promote this are therefore decisive for shaping the future of the Spanish economy.

### ***The financial system***

The behaviour of Spanish households and corporations in 2006 once again posed fresh challenges to the financial system. Given that public and private investment continued to increase, the net borrowing of the economy rose from 6.5% to 7.8% of GDP. But what is more, household and corporate purchases of financial assets inside and outside Spain increased, the result being that gross financing required by both sets of agents climbed from 35.6% to 44.7% of GDP.

Indeed, although household consumption posted a somewhat lower growth rate than in 2005, as disposable income moderated even more, household saving as a proportion of household disposable income continued falling. Given that investment in housing continued to increase at a high rate, household net borrowing rose to 1.5% of GDP. Nonetheless, changes in interest rates and property price levels themselves began to temper the demand for housing, with the volume of transactions easing off and a slowdown in prices. Yet significant underpinnings for the dynamism of housing demand in the medium and long run remain as a result of socio-demographic factors – such as the thrust of immigration, the growing incorporation of women into the labour market and the reduction in the average family size – which will continue to translate into substantial increases in the number of households. These socio-demographic factors, which were not present in the final stages of the previous upturn in this market, will allow activity to stabilise, on this occasion, at higher levels than was the case then.

In the new setting of less relaxed financial conditions, Spanish households began to resort less to credit as a means of financing their expenditure. But the slowdown was still modest, it affected only house purchase loans and it did not suffice to curb the rising trend of the sector's debt/income ratio. The associated interest burden also increased, further boosted by the rise in interest rates. Thus, although there has been some headway in Spanish households adapting their spending and saving patterns to the progressive withdrawal of the monetary stimulus, this is still limited.

In the corporate realm, however, the presence of other factors meant that the increase in interest rates scarcely affected corporate investment and debt. As earlier stated, investment in capital goods became the most dynamic expenditure component in 2006, owing principally to two factors: the pressure exerted by demand on the degree of capacity utilisation, which drew close to its historical high; and the sound results posted by most companies along with their favourable outlook.

The buoyancy of investment was duly reflected in the sector's debt ratios. These increased once again, fuelled by bank lending growth rates of around 30%. Significantly, however, a very sizeable portion of funds raised was earmarked for financing Spanish institutions' participation in various mergers and acquisitions. These M&A operations showed renewed vigour in 2006 not only in Spain but also worldwide.

As in the case of households, the simultaneous increase in liabilities and in the related borrowing costs translated into an increase in the interest burden borne by corporations. Foreseeably, the ongoing moderate rise in interest rates will ultimately emit a timely signal to companies to adjust their investment and business expansion projects to real future earnings possibilities. In that way the financial risks that might jeopardise the continuity of investment will be lessened.

The financial institutions of all countries benefited from an exceptionally benign environment, in both macroeconomic and financial market terms. Specifically, the balance sheets and income statements of Spanish credit institutions were notably sound, with returns on equity not only greater than those of the previous year but also far above those relating to risk-free assets. Their ROE stood at around a level of 20%, 3 bp up on 2005, with a spread of 16% over long-term government bond yields. These trends are similar to those observed in major international institutions, which show sound levels of returns on equity along with wide spreads over government bond yields.

Yet this situation should not lead to complacency. On the contrary, it is precisely the favourable circumstances of financial institutions, as reflected in their levels of profitability and solvency, that allows us to discuss more freely the risks and uncertainties they must face in the coming years.

Financial innovation and the activity of new market agents should be viewed as positive developments. The emergence in recent years of new products, such as credit derivatives and CDOs (collateralised debt obligations), and deeper markets for other more traditional products, such as asset-backed securities, have provided financial market agents with a new range of profit and risk possibilities, allowed more dynamic and intensive risk management, and made for greater diffusion and better diversification of risk. Similarly, the emergence of new operators, with investors prepared not only to assume new risks but particularly to do so over longer terms, has in recent years enabled shocks to be absorbed on markets with a lower level of stress and, subsequently, lower volatility. Finally, regulated and non-regulated financial institutions alike, by increasingly having better risk management systems, combined with supervisory and regulatory models based not on coercive restrictions but on providing incentives for proper risk management, contribute clearly to market stability. Unsurprisingly, as a result of

all these factors, the international financial system has demonstrated notable stability and substantial capacity to absorb adverse impacts level-headedly, ensuring that the few episodes of overreaction have been very short-lived.

However, these structural improvements should not mask the fragilities inherent in this new and more complex environment. The improvements based on proper risk management and diversification are genuine ones. But they entail considerable management complexity and the growing involvement of agents not subject to prudential supervisory arrangements who do not yet have tried and tested experience in managing the risks assumed in more adverse economic environments. Moreover, their information on such risks is abundant, but not systematised, and is fragmentary and limited in depth. It is therefore likely that the risk of financial crises in the future will be less, but it is also possible that, if such crises emerge, they will do so with greater intensity than in the past.

The improvements arising from new products and financial agents have enabled institutions to spread risks and dilute the impact that an upward revision of the risk premium might have on their balance sheets. But there is considerable uncertainty about the final destination of financial risk, since this is neither created nor destroyed, only transformed or diluted. The most desirable outcome would be for risk to end up at new institutions that can withstand negative returns in the short term without having to close out positions or cut back risk exposures.

If ultimately it is pension funds that are going to retain the risk, concern should be voiced about the mismatch between increasingly sophisticated financial markets that defuse the risk in an optimal fashion and consumers whose financial knowledge has not evolved in step with market sophistication, and who remain rooted in a very elementary financial culture.

Spanish credit institutions, with a traditional business model based on long-term relationships with retail customers, are more sheltered from this complexity than other international banks that are more active on financial markets and have deeper interactions with the markets. But in a globalised world with complex interrelations, we can no longer think solely in national terms. And especially when our financial system finances its ordinary activity not only through its Spanish customers but also with funds raised on the European market.

The growing integration of the single financial markets can now be seen in many facets. First, some market segments, of particular importance for Spanish institutions, already enjoy full integration, and talking of the Spanish environment in this connection is meaningless. The integration of the interbank markets, the public debt markets and the markets for subordinated debt and preference share issues is, quite simply, complete. In the market segments of high-volume business financing, and equities, the degree of integration in the recent period has been substantial. And in other markets, such as retail banking, a lesser degree of integration is compatible with growing cross-border competition through M&As or branches and subsidiaries. In addition to this there is the practical importance and potential impact that European regulations emanating from Brussels have for Spanish institutions. Such regulations include most notably the IFRSs (International Financial Reporting Standards), the new Capital Requirements Directive (the Basel II Directive) and the Markets in Financial Instruments Directive (MIFID).

On the basis of all these elements, the conclusion is that the prudential supervisor of Spanish credit institutions cannot disregard the growing practical importance of the European environment, which precludes thinking in strictly Spanish terms. This is so with regard to the diagnosis of institutions, to the risks they face in the medium and long run, and to the instruments they have to mitigate such risks.

Traditionally, the Spanish supervisory model has been able to combine a demanding stance in respect of institutions' risks with incentives for best-practices management. This has positioned Spanish institutions among the most efficient and profitable in the world, and the Spanish economy has benefited from a highly competitive financial system. In the coming years the challenge is successfully to transmit these values in the European context, but also to assimilate the best international – and specifically European – supervisory practices. We must allow our institutions to harness the benefits the single financial market can offer them. Accordingly, in overseeing our institutions, we should limit the inevitable cost all supervision entails, applying prudential policies that encourage appropriate risk management, through the tempered use of restrictive or coercive measures in relation to banks' activities, and through the use of more effective instruments for obtaining prudential information.

The second consideration on the European market is the need for all European supervisors to redouble their efforts as regards mutual collaboration. Indeed, we must move from collaboration to cooperation, and from there to joint action and mutual trust, if we wish to be capable of properly supervising a European financial market with increasingly blurred national boundaries.

It should also be acknowledged that the build-up over time of new European financial regulations, even though they have been beneficial to European financial intermediaries and institutions, has posed an organisational challenge to institutions. It is thus not surprising that they have called on Brussels to contain the rate at which new regulations are promulgated.

All European regulators and supervisors, including the European Commission, agree on the need for the thoroughgoing implementation of approved regulations. But we also agree on the advisability of avoiding new regulations in the coming years. The Banco de España has sought, as far as possible, to limit the attendant costs, whether through unifying accounting criteria for reporting to the market, for prudential purposes and for calculating tax bases, through the convergence of our criteria with those demanded by other supervisors, such as the so-called national discretion clauses in Basel II, or through our circulars, i.e. specific regulations that provide institutions with the necessary legal certainty. But new financial regulations cannot be dispensed with indefinitely, since it is quite possible that the very dynamics of European market integration will entail the need for new regulations in specific fields. Indeed, new reforms may even prove appropriate for Spanish institutions. For example, the fragmentation of deposit guarantee arrangements in Europe, in terms of financing, structure and organisation, might warrant a new Directive, which in turn would level the playing field, given the greater rigour of the Spanish system.

I would not wish to conclude these considerations on the growing importance of the European component of our financial system without referring in particular to the euro area financial market. Indeed, financial integration is even greater for the European countries making up the euro area: their banking systems draw on a common pool for their funds, through bank loans, medium-term financing (whether subordinated or not), securitisations and mortgage covered bonds. The existence of this integrated market for the euro area has allowed certain financial systems in the area to finance their economy's upturn with the funds from other financial systems operating with less pronounced cycles. This is a most favourable development as it allows financial institutions with surplus funds to earn more efficient and higher returns, thereby sustaining the profitability of their business, while providing demanders of funds with more stable financing for their most profitable lending business. Evidently, the outcome for the euro area economies is a more efficient use of financial resources, which are routed towards the most productive activities.



Let me now analyse in greater detail the situation of Spanish deposit institutions. As earlier stated, their banking activity grew notably in 2006 both as regards lending to corporations and to households. This sizeable increase in activity is one of the reasons behind the highly favourable earnings performance of Spanish institutions. However, if activity were to slow in the future, income statement margins might suffer. In that case, as in any other business, but all the more so in an industry as competitive as Spanish banking is, it would be of paramount importance to have flexible cost structures capable of adapting to new scenarios. Indeed, once the property market has moved onto a more moderate path, institutions will not only be confronted with a volume challenge, but also one of type of business. Specifically, they will progressively have to limit the importance accounted for by the property sector in their lending portfolios in recent years, moving towards other activities.

In the design of these strategies it is to be hoped that easy, short-termist decisions, but which have highly negative potential in the medium term, will not be adopted. Entities should not succumb to the temptation of offsetting the slowdown in demand with a decline in credit quality standards.

Recently, some concern was detected in this connection in the US mortgage market, especially in relation to subprime lending to the least creditworthy segments of the population. Such lending in the United States is usually to borrowers with a poor credit history or with little documentation of income that makes it difficult to properly assess their creditworthiness. In Spain, if we identified as subprime those operations with individuals who at some point in the past have failed to meet their credit obligations, the amounts extended to such individuals would stand at around 1.27% of the overall mortgage funds lent, compared with levels for the US subprime market of around 14% of mortgage loans. That is to say, if there were a business segment of this type, it would be very small. Bad debt ratios in the Spanish mortgage market stand at 0.4%, compared with 4% in the United States. The information available for Spain therefore precludes talking of a market of this type.

Regarding bad debts, the aggregate ratio for the sector during 2006 was on a declining trend and, in any event, is holding at minimum levels, whether analysed from a historical perspective or in comparison with institutions in other euro area countries. In other words, this indicator of the credit risk borne by institutions is not currently showing signs of difficulties feeding through to the industry, and this despite the higher growth of doubtful assets over the course of 2006. This higher growth, however, must be analysed bearing in mind at least two considerations. First, the increase in doubtful assets is due in part to the strong growth in activity recorded in recent years. In an expansionary setting it is logical that, if the volume of credit increases, the volume of doubtful assets will afterwards increase with some delay even if default probabilities hold constant. Second, it should not be forgotten that the changes in accounting rules introduced by the Banco de España to adapt to International Financial Reporting Standards mean that doubtful assets must be recognised earlier and in a higher proportion.

That said, and while acknowledging the low default levels in the Spanish banking system, it seems clear there is no further room for further reductions in the ratio. Looking ahead, against a background of slowing credit growth, these ratios will conceivably tend to rise, converging at levels that may be considered as more normal in such a setting, while similar to those prevailing among our European partners. Moreover, both past experience and the findings of various studies show that risk tends to emerge with some delay in relation to the time it is assumed. In any event, a rise in the doubtful assets ratio should not in itself be viewed as a cause for alarm; it should rather be understood as another of the various indicators needed to assess institutions' financial capacity.



Although deposits trended more favourably in 2006 than in previous years, institutions had to resort to securities issues, subordinated financing and asset securitisations to meet the growing demand from households and firms for funds. Going to international markets in search of funds may make Spanish institutions more sensitive to external difficulties while exerting additional pressure on their operating margins, although it is true that resort is mainly to the euro area markets. Indeed, the fact that Spain has joined this area of stability has meant that our institutions have been able to finance an expansionary process like the one we have experienced.

One positive aspect is that institutions are raising finance especially by resorting to medium-term resources, which are more stable than those that might be obtained on the interbank market. Insofar as the secondary markets are sufficiently liquid, subordinated debt or preference share issues can contribute to greater market discipline. Moreover, asset securitisations allow a portion of risks to be transferred towards other investors, thereby contributing to better risk management.

Despite the challenges ahead for Spanish institutions, their resilience was heightened in 2006. Profits – the first line of defence against potential problems – not only increased notably but were also sound. This was reflected in the main income statement margins which, combined with moderate growth in operating expenses, contributed to the favourable dynamics of earnings last year. The return on equity increased once again, maintaining, as earlier indicated, a wide spread over long-term government bond yields. The solvency of Spanish institutions held stable in 2006, with the attendant ratio comfortably above regulatory requirements. This came about, moreover, in a setting in which the sharp growth of activity exerted upward pressure on capital requirements.

Earnings in 2006 and solvency levels thus attested to the sound position of Spanish institutions. And this was further corroborated by the available market indicators, by the stress tests conducted during the IMF Financial Sector Assessment Programme (FSAP) and, subsequently, by the loss distribution method, which shows that, even in a highly unfavourable scenario, any losses generated would be amply covered by the capital in the system.

I should not wish to conclude this address without highlighting the need to further efforts in the financial education of consumers. In early 2007 the Banco de España released a new version of the Bank Customer Portal, but much remains to be done. The growing complexity and sophistication of the international financial system is, as I mentioned, creating a “knowledge gap” between financial institutions and final investors. And far from closing, the gap is widening. Supervisors, along with the other authorities involved in safeguarding consumer rights, must step up and, above all, combine their efforts in this field, since bank customers with a sound financial grounding are a vital pillar in a sound, competitive and stable financial system.

It remains only for me to express my thanks, which it is a pleasure to do. During these first 11 months of my term of office I have had the good fortune to work closely with this Governing Council, the Executive Commission, the Deputy Governor and the Directors General, and to have received the firm support of the Bank’s staff. I thank you all and, after having celebrated the 150th anniversary of the adoption of the name Banco de España, I can bear witness to the fact this institution is performing increasingly better the tasks entrusted to it.

