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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 2012*

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Ladies and gentlemen,

The year 2012 was a difficult one for the economy: for the world economy, which was unable to resume firm growth; for the euro area, which experienced a very serious confidence crisis; and, of course, for the Spanish economy, which had to face a double-dip recession, a further and forceful increase in unemployment, major external funding tensions and a banking crisis.

The international setting

There was a further decline in world economic activity and trade in 2012. Global GDP grew by little more than 3% and the increase in trade was below this figure. These aggregate developments mask differing patterns of behaviour, since compared with the dynamism of the emerging economies, the United Kingdom and the euro area went back into recession, while US GDP, driven by domestic demand, ran at above 2%.

On the international financial markets, however, the year 2012 ultimately provided more grounds for being upbeat than downcast. Following a first half marked by worsening stock prices and the widening of sovereign and credit spreads on the debt and interbank markets, there was a turnaround after the summer that more than offset the previous decline in most financial stability indicators.

Several factors contributed to this easing of global financial tensions. One of the most important was the continuation of expansionary monetary policies; the search for yield in a low interest-rate environment; and the fact that certain critical junctures were overcome, such as those linked to the US fiscal cliff, the revision of the financial assistance programme for Greece and doubts about it remaining in the Monetary Union.

Unquestionably, the event that most influenced financial markets last year was the euro area crisis. The euro area experienced and ultimately overcame what was the greatest episode of tension in its still-short history.

The problems at the root of this crisis are of two types.

On one hand, national economic policy management did not adapt sufficiently to the stability requirements inherent in belonging to a monetary union. Imbalances progressively built up in a group of economies and ultimately emerged when growth lost momentum. Some of the biggest economies in the Monetary Union were affected, such as Italy and Spain, which contributed to the crisis taking on a systemic dimension.

On the other, the tensions in the area highlighted the shortcomings in the institutional design of Monetary Union, which restricted responsiveness at the outset of the crisis and were conducive to doubts emerging over the soundness of the project. The mechanisms envisaged in the Maastricht Treaty for the coordination of non-monetary policies and for the correction of slippage in public finances proved insufficient. In turn, the ways and means to manage the bouts of turbulence and risks that were unleashed in the first half of 2010 were not there.

Given the source of the underlying problems, twin solutions involving national economic policy management and euro area governance are needed. I shall presently address the national policy issue, from a perspective focusing on the specific challenges of the Spanish economy. But I would first like to mention the progress made in European policies.

The first steps in reforming euro area economic governance were geared to strengthening budgetary policy surveillance mechanisms, thus reaffirming the central role of the European Commission. The coordination and mutual supervision processes likewise spread to economic policy areas other than the fiscal realm, with the creation of the Macroeconomic Imbalances Procedure in which, as in the case of the renewed Stability and Growth Pact, management responsibility is the preserve of the European Commission. In the macroprudential area, the start-up of the European Systemic Risk Board should be mentioned, as should the central role assigned to the European Central Bank in its functioning. Lastly, the European Stability Mechanism (an intergovernmental agency, as opposed to the above) has been set in place. The ESM fulfils the need for a permanent institution to channel euro area financial support to the economies that need it, under the programmes agreed with European institutions.

While the reform of governance is a prerequisite for stabilising the Economic and Monetary Union, to anchor it measures are needed to move beyond what is exclusively a monetary union. In June last year, the euro area Heads of State and Government agreed on an ambitious project encompassing four major areas: banking union, economic union, fiscal union and the setting in place of mechanisms to ensure the democratic legitimacy of the entire process, i.e. political union.

The difficulties of this project are evidently enormous, but significant progress on banking union has been made. On one hand, the European Council and Parliament have already discussed the regulations governing the creation of the Single Supervisory Mechanism, whose final approval is expected for July this year. As a result, the SSM might be up and running in July 2014. Further, the Directive on the Recovery and Resolution of Financial Institutions, which will harmonise bank resolution arrangements at the European level, is close to being approved by the European Council and Parliament. Conversely, there has been little headway in discussing the creation of a common resolution and deposit guarantee fund or funds, which would be the other key pillar of the banking union project.

As for the European Central Bank, since the start of the tensions in 2007 the single monetary policy stance has become more expansionary, both through interest rate cuts and through the liquidity provision policy, which has been pivotal to easing the effects of the crisis on bank funding. In parallel, other measures have been adopted, including most notably the approval in August 2012 of the Outright Monetary Transactions programme, an initiative which rapidly and appreciably influenced market expectations, reducing the government debt yield spreads of the countries with most difficulties, Spain among them.

The double-dip recession in the Spanish economy

Let me deal now with the Spanish economy and our economic policy.

In late 2011 the Spanish economy went into a second recession, one less acute but more protracted than that in 2008-2009, and deeper than that the euro area is experiencing. The contractionary trend of domestic spending was partly offset by the external sector, which continued to make a positive contribution to GDP, owing to the buoyancy of exports – despite being affected by the cyclical downturn in the euro area – and the marked fall-off in imports, mirroring weak national demand.

Employment fell for the fifth year running and the unemployment rate climbed in the first quarter of 2013 to 27% of the labour force. The decline in employment last year showed, for the first time in these years of crisis, a fall in public-sector employment, which added to the ongoing adjustment in private-sector employment.

Spain underwent a serious external funding crisis in 2012. This should be set against the crisis in the euro area and negative market perception of the solvency of our banking system – sharply compounded by the Bankia crisis – and against the doubts over the sustainability of our public finances in light of the continuing recession.

Against this background, a feedback loop between sovereign risk and banking risk emerged, dominated by the so-called "redenomination risk", i.e. the risk that certain countries might abandon the Monetary Union and the euro. This risk prompted a surge in the yield on Spanish government debt, which reached its highest level since the onset of the Monetary Union, and almost a collapse in our external funding, which the European Central Bank offset for much of 2012 through its provision of liquidity to Spanish banks.

In the closing months of 2012, tensions receded in the euro area. Notable influential factors here were the dispelling of doubts over Greece remaining in the Monetary Union and the approval of the Outright Monetary Transactions programme. This helped our banks and companies regain access to the interbank and capital markets. But also influential, no doubt, was the headway made in fiscal consolidation and the clean-up of our banking system, along with the progress in the external adjustment and the reforms undertaken, particularly the labour market reform. I shall now address these issues.

The policies and reforms adopted

Correcting the imbalances in our public finances is, as we are all aware, proving to be a most arduous task. Indeed, 2013 will be the fourth consecutive year in which the general government structural deficit will be cut following the end of the boom in the construction and real estate sector and the entry of our economy into recession. Significant progress was made in 2012 both in reducing the imbalances and in strengthening the budgetary discipline and management framework.

The successive adjustment measures have affected a broad range of items: on the revenue side, with rises in VAT, direct taxes and property tax; and on the expenditure side, including health and education reforms, pensions and cuts in investment and in public-sector wages. The fiscal consolidation in 2012 has become extensive to all tiers of government, giving greater credibility to the Government's commitment to budgetary stability. General government net borrowing has been reduced to 7% of GDP, once the impact of the aid to financial institutions is stripped out, though the figure would be 10.6% of GDP if such aid were included. The intensity of the adjustment is apparent if we recall that the general government primary deficit was reduced to 4%, and the primary structural deficit stood at 2.1% in 2012. Indeed, this latter figure is expected to be in balance or run a slight surplus for the current year, 2013, according to the estimates of the updated Stability Programme.

In terms of budgetary discipline and management, several key initiatives were adopted.

The new Budgetary Stability Law has strengthened the overall general government fiscal discipline framework. In the first year it has been in force, it has significantly improved information on the budget outturn, and this progress should continue with the application of the Law's mechanisms to correct slippage. The creation of the Independent

Fiscal Responsibility Authority, envisaged for this year, should entrench this progress by adopting the best international standards in terms of its mandate, resources and governance.

Mention should also be made of the Payment to Suppliers Plan, which contributed to easing cash management issues at many small and medium-sized companies and to mitigating the restrictive impact of fiscal consolidation in the short term. The State-intermediated Regional Government Liquidity Fund was also set up, to address regional governments' difficulties in accessing capital markets.

Despite the achievements in cutting the budget deficit, the scale of the adjustment remaining is still highly significant, especially bearing in mind the dynamics of public debt which, on current growth and inflation assumptions, might stand at around 100% of GDP in 2015. The new fiscal consolidation path recently announced by the Commission, under the recommendations of the European Semester, sets the deficit target for this year at 6.5%, and at 5.8% for 2014. Here it will be of great importance to consolidate the gains in credibility by establishing a medium-term budgetary horizon and adopting additional reforms, in particular in respect of pensions, with the approval, as foreseen, of an appropriate definition of the so-called "sustainability factor".

The achievements in the budgetary field have been complemented by substantial amendments to labour market regulations. These have sought to influence collective bargaining, the internal flexibility of companies, hiring arrangements, contract termination costs and labour intermediation. Greater flexibility and moderation, and a lesser degree of indexation, are already patent in the wage-setting process. But given the structural nature of this reform, it will admittedly take time for all its effects to work through.

The adjustments made: external sector and deleveraging

Along with the fiscal consolidation drive and the labour market reform, the adjustment in the external sector and the ongoing deleveraging by Spanish households and firms should be highlighted.

Further headway continued to be made in correcting the external imbalance in 2012; the current account deficit fell to 0.2% of GDP, with a surplus being recorded in the second half of the year, an unprecedented development since the introduction of the single currency. Forecasts suggest this positive trajectory of the balance of payments will firm in the coming years.

This has been possible not only due to weak domestic expenditure, but also to the correction of the loss of competitiveness built up throughout the previous expansionary cycle. In terms of unit labour costs, two-thirds of the difference accumulated relative to the euro area average since the start of Monetary Union had already been corrected by late last year. These gains in price competitiveness have been accompanied by notable growth in the number of Spanish exporting companies and by the greater geographical diversification of our exports, especially towards emerging markets with high growth potential.

Compared with the progress in the adjustment of the external sector, headway in the deleveraging of Spanish households and firms has been more modest. The double-dip recession and slack income restricted the possibility of reducing debt ratios. The bulk of the adjustment was based once more on the containment of credit, which limits the speed of the process.

The reduction in credit is not only in response to the decision and need to correct household and corporate over-indebtedness, but also to the lacklustre macroeconomic outlook and to uncertainty, which check the demand for financing. And compounding this are the constraints on banks' supply of credit. Under a simple framework, such constraints may be due to four possible factors: liquidity, capital, perceived borrower credit risk and financing.

The first two factors are unlikely to be restricting at present the supply of funds. I referred earlier to the Eurosystem's liquidity policy, which cannot be considered tight. As to capital, the efforts made in recent months have enabled the sector as a whole to achieve reasonably comfortable solvency levels. Elsewhere, analyses conducted at the Banco de España point, in any event, to a negligible contraction in credit attributable to banks which have had to restructure owing to their capital weaknesses.

Yet the deterioration in the overall creditworthiness of Spanish households and firms, as a result of the double-dip recession, is proving to be an important factor for credit developments, although this is of course compatible with the existence of companies that obtain funding for potentially profitable projects. The Annual Report being presented today offers some evidence that less leveraged and more dynamic companies are in fact increasing their access to credit.

The supply of credit may also have been affected by banks' difficulties in raising funds on wholesale markets, and by the persisting fragmentation of euro area financial markets, which prevents the expansionary impulses generated by monetary policy from passing through sufficiently and uniformly to all the euro area countries.

Given all these factors, it is difficult to conclude whether the credit contraction should be attributed to a greater extent to supply-side or demand-side factors. Undoubtedly, however, the fragmentation of euro area markets does mean that Spanish households and firms face higher financial costs than those which, in principle, would correspond to the current single monetary policy stance. And it likewise seems that the more restrictive effects tend to mainly bear down on small and medium-sized enterprises. This, in my view, is a problem that justifies designing measures geared especially to this sector.

Clean-up, recapitalisation and restructuring of the banking system

Along with the progress made in terms of fiscal and budgetary policy, labour market reform and the external sector, our banking system underwent a major clean-up in 2012. The starting point was the two decree-laws published in February and May, which compelled banks to make a major provisioning effort, culminating on 20 July with the Memorandum of Understanding agreed with the European Commission, which included a Financial Assistance Programme for up to €100 billion.

The strategy designed in the Memorandum of Understanding was four-pronged: the identification of credit institutions' capital needs; the recapitalisation, restructuring or ultimate orderly resolution of vulnerable banks; the clean-up of balance sheets; and, finally, the refining of various aspects of financial regulation. Allow me to refer briefly to the content of the reform in each of these areas.

Capital needs were assessed on the basis of a rigorous analysis of the solvency and business prospects of each of the main Spanish credit institutions, which make up more than 90% of the sector. To do this, bank balance sheets were revised and subjected to a stress test to assess each bank's capacity to maintain specific capital ratios in two different macroeconomic scenarios: a baseline scenario and an adverse scenario. As is known, the exercise resulted in estimated capital needs for Spanish banks of somewhat less than €57 billion. These needs were mostly concentrated in a group of four banks, which were already majority-owned by the Fund for the Orderly Restructuring of the Banking Sector (FROB). For the bulk of the Spanish financial sector – made up of institutions accounting for around three-quarters of it – it was estimated that banks were capable of maintaining their solvency with their own resources, even under the adverse scenario.

To ensure the quality of the exercise, a sound governance structure was set in place with the participation of the Banco de España, external consultants, the main audit firms and several real estate valuation companies. The entire process was overseen by a committee on which, along with the Spanish authorities, the European Commission, the European Central Bank, the European Banking Authority and the International Monetary Fund sat. It was a rigorous exercise, as acknowledged by most of the observers, and a sound basis on which to design the recapitalisation and restructuring processes for the most vulnerable banks.

The starting point of these processes, which are the second element of the strategy, was to determine the volume of public aid required by banks that had evidenced a capital shortfall in the stress tests. In aggregate terms, the public aid, which has already been paid out in full, stood finally at €39 billion. To arrive at this figure the following was taken into account: each bank's ability to raise capital by its own means, the effect of the segregation of impaired assets – which I shall discuss later – and, above all, the effect of the hybrid instrument management exercises, following the principle of burden-sharing in order to minimise the public aid and the cost to taxpayers.

Under the Memorandum of Understanding, the EU regulations on State aid and Spanish law, holders of preference shares and subordinated debt should contribute to covering capital needs. This principle has been applied through haircuts to the value of each instrument, calculated in terms of its characteristics and, in most cases, its conversion into instruments eligible as top-quality capital, like ordinary shares. For cases in which the shares offered in the exchange process are not quoted on a regulated market, a liquidity mechanism to be implemented by the Deposit Guarantee Fund will shortly be established and made available to retail investors who wish to use it.

Notwithstanding, the banks controlled by the FROB have established arbitration mechanisms. These follow the guidelines set in place by a purpose-designed monitoring committee and are aimed at simplifying the processing of claims for damages by retail investors in connection with possible mis-selling.

Significantly, all banks that have received public aid are subject to restructuring requirements involving demands in terms of size, cost saving, limitations on the distribution of dividends and restrictions on their commercial practices, among other factors. These measures are essential to ensure their viability and to lessen competition-distorting effects. Further, in the case of the four banks declared in resolution, the Memorandum demands the sale of the public holding to another market participant within five years at most.

Currently, two of the banks with public aid have already been sold, a third is in the process of being absorbed and, under its resolution plan, the fourth is considering a potential integration into another banking group. Finally, a fifth bank which also received public aid has recently been listed on the stock market.

Accordingly, I believe significant steps are being taken to restructure and consolidate the sector, with viable, well-capitalised groups at its core. There will be further action in the near future along these lines involving the design of a divestment strategy by the FROB for the two banks in resolution still under its control.

The third ingredient of the Spanish financial sector reform strategy is the clean-up of bank balance sheets. The weakness shown by part of our banking system is known to have been linked to over-exposure to the real estate development sector. After the approval in 2012 of the two royal decree-laws, which established stringent provisioning requirements for assets linked to real estate activity, the Memorandum of Understanding further acknowledged the segregation of the impaired assets of banks requiring public aid and their transfer to an asset management company to be central to the clean-up process. To this end, SAREB (the asset management company for assets arising from bank restructuring) was created and is now fully operational. It is majority-owned by private capital, and its purpose is the orderly management and divestment of the asset portfolio it has received, over a horizon of 15 years, which is the maximum life established for the company. Significantly, with these clean-up measures, Spanish banks' exposure, net of provisions, to the real estate sector has been more than halved.

Finally, regulatory changes make up the fourth component of the reform. The scope of the changes made or proposed in recent months in the financial arena has admittedly been substantial. Without giving an exhaustive list, I might mention the approval of the law on the restructuring of credit institutions (which largely mirrors the content of the future European directive on the subject), the raising of solvency requirements, the new savings bank law and the greater regulatory powers conferred on the Banco de España. There are also the new transparency requirements, addressing sensitive exposures and restructured or refinanced loans, which the Banco de España has introduced through the related circulars.

Banking supervision and macroprudential policy

In relation to banking supervision, the Memorandum of Understanding of 20 July 2012 included the Banco de España's commitment to internally review its supervisory procedures. In fulfilment of this undertaking, a committee was set up to make a diagnosis of these procedures and to identify and formulate proposals for reform. The committee issued its report last October.

The committee's main recommendations proposed, inter alia, defining a standardised framework for the adoption of supervisory measures based on each bank's risk profile; the full implementation of on-site continuous monitoring of all major banking groups; improvements in the formalisation of supervisory actions; and the establishment of a structure and procedure to properly bind micro to macroprudential supervision.

The creation of the Single Supervisory Mechanism at the European Central Bank, whose start-up is expected for July 2014, will entail the need for Spanish banking supervisors, and all other European supervisors joining the Mechanism, to adapt their organisation and procedures. This process will take time, and it should be undertaken with all due prudence and, naturally, in coordination with our partners and the European Central Bank.

One of the lessons of the crisis has been a need to complement the conventional approach of regulatory and supervisory policies, which have traditionally focused on ensuring the solvency of banks taken individually, with a new macroprudential approach, geared to ensuring the stability of the financial system as a whole.

The aim of macroprudential policy is to prevent or mitigate systemic risks that can significantly affect the real economy. Adopting a macroprudential approach means, among other things, acting ahead of events in an attempt to prevent the growth of credit and debt from reaching dangerous levels in economic upturns, evaluating the systemic implications of liquidity risks and financing, restricting risk concentration and introducing measures aimed at internalising banks' contribution to aggregate risk.

We might recall that the Banco de España pioneered the roll-out of some of these policies, introducing in 2000 the so-called "dynamic provisions" aimed at improving credit risk coverage. This instrument proved to be limited in its capacity to check credit in the upturn and, with hindsight, additional measures would have been desirable to restrict the build-up of risks. But its counter-cyclical thrust was appropriate and the evidence is that it provided a substantial loss-absorption buffer during the crisis.

In any event, there is broad consensus about the need to strengthen the macroprudential policy framework, creating bodies or authorities with the explicit remit to preserve financial stability. In recent years several countries, including the United States, Germany, the United Kingdom and France, have created, or are going to create, new macroprudential policy bodies, something that is also planned at the European Central Bank in connection with the Single Supervisory Mechanism. Indeed, in late 2011 the European Systemic Risk Board issued a recommendation to national authorities to pursue initiatives in this area, indicating various broad principles on the objectives, institutional characteristics and main functions of this new direction in financial stability policy.

In accordance with this recommendation, the Banco de España and the Spanish Ministry of Economic Affairs and Competitiveness have participated in a committee set up to reflect on this issue. The committee began its work last October and approved its final report just a few days ago.

While certain details of the new institutional framework are still to be finalised, its main characteristics have already been defined. A Board shall be set up at the Banco de España, with the participation of the ministries with competencies in the financial area and of the Spanish National Securities Market Commission (CNMV), whose function will be to propose measures aimed at preserving the stability of the financial system, considering all economic policy and financial regulation and supervision instruments. We trust the new body will be set up and ready to commence work in 2014.

The outlook for growth and employment

The latest conjunctural indicators suggest that the worst phase of the double-dip recession currently under way was in the second half of last year. Since then, the recovery in exports and the stabilisation to some extent of private consumption have been softening the quarter-on-quarter declines in GDP and should pave the way for a modest recovery in 2014. However, this recovery is most likely to run, for some time, in tandem with an unemployment rate that is still too high.

The foreseeable path of recovery is not free from risk. To successfully negotiate the road ahead, all supports for investment and job creation must be bolstered.

These include most notably the potential in place to obtain economy-wide gains in competitiveness. Harnessing this potential essentially involves promoting the reallocation of factors of production towards those more dynamic sectors capable of generating added value and competing in international markets. And here, deepening the reforms aimed at improving the functioning of the markets for factors and for goods and services will play a key role.

The factor markets should allow companies to have access under economically attractive conditions to capital accumulation and job creation. In the labour market, taking full advantage of the flexibility mechanisms introduced in the recent labour reform will allow for the more efficient and intensive use of this factor, i.e. it will give a sustained boost to job creation.

I wish to conclude with a reference to our banking system, which is a core and pivotal part of our financial system. The Banco de España has ultimate responsibility for the functioning of the banking system, which has witnessed major steps in the past year to strengthen its solvency, increase transparency and improve its organisation and efficiency.

In the immediate future it will be important for banks to contribute to optimising the impact of the reforms undertaken in 2012, placing a more rigorous emphasis on its policies on management, on the remuneration of managers and shareholders, and on public financial disclosure. By doing so our banks will be in a position to contribute, under a framework of financial stability and strengthened solvency, to promoting the access of households and firms to financing, and to the recovery of economic activity and of employment.

Thank you for your attention.

31 May 2013.