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Dear President Vergara, Dear Vice-President Constancio, Dear Colleagues, Ladies and Gentlemen,

It is for me a real pleasure to participate in the 6th edition of this Seminar of Governors of the Eurosystem and Latin American Central Banks and to be given the opportunity to address this speech to you.

The Banco de España has been co-organizing this High-Level Seminar with the ECB since its first edition, in 2002. Also, when the Seminar has crossed the Atlantic –to Brazil, in 2004, to Mexico, in 2009, and now to Chile- we have had the pleasure of collaborating with our Latin American colleagues; on this occasion with the Central Bank of Chile. So, as a co-organizer, I would like to welcome you all, too. [Sean bienvenidos. Sejam Bem-vindos.]

A dinner speech is expected to be both light or, at least, let's say, not very heavy and, in any case, brief. This should be the case, especially because this has been a long day for many of us, just arrived from far away to this marvellous country. To be light is not going to be easy. The circumstances in the Eurozone -and particularly in some member countries, Spain among them- would make it rather artificial for me to skip in my address to you tonight, the hard issues we are facing in Europe. But I'll try, at least, not to be too long.

When this series of Seminars started a decade ago, things among the countries gathered here today were very different. Latin America was going through yet another episode of regional financial stress –in the aftermath of the Argentinean crisis- and the euro area was still benefiting of the smooth start of the euro and the brilliant prospects offered by the Monetary Union. At present, the euro area is entangled in a serious crisis, whose roots --with hindsight- were already taking hold by 2002.

The strong push towards economic and financial integration that accompanied the process of accession and the setting up of EMU triggered a period of intense economic convergence among member countries. This was especially the case in countries such as Spain, which had joined the project starting from real income levels below those of the main economies of the area.

However, this process went hand in hand with the accumulation of imbalances at the domestic and European levels. The deep integration of European capital markets –one of the most remarkable features of the Monetary Union- resulted in a large availability of financing to those economies whose prospects were perceived as brighter. In this process, Spain has become a sort of case study.

In fact, the underlying fundamentals of the Spanish economy were not as solid as they seemed: product and labour markets suffered from structural rigidities and the expansionary cycle was underpinned by an intense increase in credit and an overexpansion in housing, even taking into account the increasing demand generated by immigration and tourism.

Between 1999 and 2007, the weight of housing investment in Spanish GDP doubled to above 12%, one of the highest on record among advanced economies. To a significant extent the financing of this housing boom came from core European countries, intermediated by their financial institutions, and resulted in a rapidly increasing external indebtedness of our private sector.

The corresponding widening current account deficit was not only a signal of robust internal demand; it also reflected a gradual, but substantial, loss of competitiveness. The large increase in employment –5,5 millions between 1999 and 2007 (a 37% increase). many of them immigrants- generated in the construction and other labour intensive sectors, interacted with the dysfunctions of the labour market, leading to very low productivity gains and increases in relative labour costs, also in the more competitive sectors of our economy.

Additionally, the housing boom and the economic expansion gave rise to an extraordinary increase in public revenues, providing for a significant increase in government expenditure. In fact, public accounts kept improving, so that fiscal surpluses, of around 2% of GDP, were achieved in the years previous to the crisis. But the temporary nature of those revenues and the underlying fragility of the fiscal situation became evident when the housing sector started to adjust. As a result of this adjustment and the depth of the crisis, the surpluses have turned into large and persistent deficits, reaching -11% in 2009, a shift of more than 13 percentage points of GDP in just two years.

Could this build-up of imbalances have been avoided or mitigated? With hindsight, no doubt it could, but the economic and policy incentives were not there at the right time.

On the one hand, financial markets failed to provide enough ex-ante market discipline: European and global investors were eager to finance countries with higher expected short term returns, dismissing underlying vulnerabilities. Investors tend to ride the waves of sentiment, reacting only --but dramatically- when weaknesses become evident. In this way, they act procyclically, inducing large swings in capital flows. Our Latin American colleagues are acquainted with these experiences, because they have suffered this type of 'sudden stops' several times over the last decades.

On the other hand, economic policies did not respond adequately to the underlying dangers. In a context of apparent economic and financial stability, and with the European project sailing in full swing, complacency was difficult to avoid, and there was little incentive to address --or even assess- underlying problems. This applies both to the European and the domestic spheres.

The surveillance framework operating at the European level was mostly focused on the fulfilment of the fiscal targets embodied in the Stability and Growth Pact. However, this framework revealed itself insufficient and ultimately ineffective, both because it relied on nominal deficit thresholds –which masked fiscal vulnerabilities under the umbrella of a large cyclical increase in revenues- and because it was loosely applied.

In several Euro area countries, Spain among them, the structural policies that could have set the basis for a more lasting and sustainable growth path were timid in a period when the economy was supported by a favourable environment. This is not, by the way, a European peculiarity: as we all know, structural policies tend to be implemented out of necessity, that is, not in the good, but in the difficult times.

However, the narrative of the financial crisis in Spain somewhat differs from other developed countries. Our financial system was not exposed to the complex structured assets which were at the root of the financial crisis in 2007-2008. But, while we did not hold this kind of toxic assets, we have suffered the toxification of the housing sector assets as the crisis deepened.

The freezing of the global financing markets that started in mid-2007 also disrupted our financing patterns (heavily dependent, as I have said, on external funds directed towards the housing sector). The situation only got worse when the sovereign crisis --that started in Greece in late 2009- progressively spread to other euro area countries with vulnerable fundamentals.

As we have seen in our discussions today, the trigger of the crisis in the euro area shows, to a certain extent, similarities to those that affected Latin America in the past: a stop in foreign capitals inflows, which induced severe financial stress and real adjustment. But also differences, due to the fact that this reduction of capital flows took place in a highly integrated monetary union, with its own peculiar adjustment mechanisms, leading to the segmentation of the euro area capital markets. These peculiarities also contribute to explain the huge magnitude and depth of the crisis. The scale of the imbalances and adjustments surpasses those in Latin American past experience.
Correspondingly, the challenges that individual countries and the area as a whole are facing are daunting. Indeed, the policy response to the crisis --both at the national level and at the level of the EU and the euro area authorities- has been substantial, particularly in the structural and institutional dimensions.

The euro area authorities have realised that, in parallel to the management of the crisis, a reshuffling of the European governance and a strengthening of the institutional framework are necessary for the long term sustainability of EMU. But, the slow process of decision making in Europe, the difficulties of policy implementation and the debate around the burden-sharing of the crisis have limited the positive effects of those policies on confidence and credibility.

In this setting, the ECB and the Eurosystem have played a central role. While safeguarding their paramount objective of price stability, their actions have been directed to re-establish the proper functioning of the transmission mechanism of monetary policy, as shown by the recent decisions by the Governing Council on the O[utright] M[onetary] T[ransactions] initiative

Some big steps have been taken on the institutional front at the European level. Fiscal rules have been strengthened and refined, governance reinforced and, in the financial sphere, great progress is being made to establish a common supervisory framework. In parallel, national constitutions have been adapted in several countries -Germany, Spain and others- to comply with these new requirements.

This overview of the problems and challenges in Europe may be compared with the evolution of Latin America during the crisis and its aftermath.

The Latin American performance during the crisis shows that these countries have drawn the lessons from the similar episodes they went through in the late nineties and early 2000's. In particular, I would highlight two characteristics of the economic setting that has made the region so resilient to the external shock this time: the improved macroeconomic framework –underpinned by price stability- and the reinforcement of financial stability.

A recurrent vulnerability of the region has traditionally been the reliance on foreign currency denominated financing. This financing pattern was exposed to sudden stops in capital flows. With the progressive achievement of price stability, the attractiveness of local markets and local currencies increased and the Latin American authorities took this opportunity to promote the development of their domestic financial markets.

The widening of the local banking base has been an essential complement to this policy. Foreign banks investing in the region have played an important role in a context of financial and banking liberalization. Most of those foreign banks brought a model based on retailing that fitted particularly well the need to strengthen the local financial base. The fact that many of the subsidiaries had to finance themselves locally –independently from parent institutions- also helped to promote financial inclusion among the population and contributed to reduce external vulnerabilities.

Conclusions

The economic and financial crisis in Spain and other euro area countries –with its particular mixture of international and domestic elements- has also brought important lessons in terms of financial stability.

One of them is the relevance of the macroprudential layer of supervision and the fact that having a good micro-prudential supervision is a necessary, but not sufficient condition to build a resilient financial system. There is the need for developing the framework and the tools to ensure that the macro perspective is duly taken into account. The recent BIS report on macroprudential instruments –presented in our last meeting in Mexico- is an good step in that direction. However, the report and the discussion surrounding it also highlights the difficulties of setting up a proper macroprudential framework, at the local, regional and global level.

Another lesson I would like to mention refers to the importance of a close cooperation between home and hosts supervisors, which has materialized in Supervisory Colleges, playing an important role in this context. Indeed, the setting up of the European Single Supervisory Mechanism, a process which will have its starting point next year, will entail new challenges for euro-zone supervisors, who will also need to develop new procedures in their relations with supervisors of other regions.

Before concluding, I would like to thank Banco Central de Chile and President Vergara for the hospitality and the perfect organization of this event, the European Central Bank for the collaboration and support and all the participants for their interest.

I wish all of you a very good continuation of the Seminar tomorrow and a very pleasant stay in Santiago de Chile.

Muchas gracias a todos. Muito obrigado.

Thank you very much for your attention.