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Interview with the Governor in El Periódico

Pablo Hernández de Cos, Governor of the Banco de España

The Governing Council of the European Central Bank (ECB) began to discuss reining in the restrictive stance of monetary policy at its last meeting. Does the most likely current baseline scenario envisage a rate cut in June?

We aren't giving any explicit guidance, but that is consistent with our giving signs to the market and the wider public about what we may do in the future. If you account for the fall in headline (and underlying) inflation in recent months, the feebleness of growth in the euro area and the robustness of monetary policy transmission, and if our macroeconomic projections hold true in the coming months, the natural response would be a rate cut soon and June could be a good time for it.

And do you think there'll be consensus within the Governing Council?

The differences within the Governing Council are well founded and enrich the debate. Moreover, until now they have been relatively limited. In any case, I think that we are currently very much in agreement and I hope that continues.

Market expectations are for more or less three cuts of 0.25 basis points between now and the end of the year. Does that sound reasonable to you?

In line with the Eurosystem projections, in which our confidence has grown greatly in recent months (since the prediction errors regarding changes in inflation have been brought down significantly), the yield curve that we see in markets now is in line with our fulfilling our medium-term inflation target of 2%. But I don't want to venture further. There is currently an elevated level of uncertainty, which means that we must not be overly categorical with regard to expectations for future interest rates. The reality is that the yield curve in markets is not settled and reacts to constantly collected data, especially relating to GDP, employment and, of course, inflation.

There is some debate over whether the ECB is making a mistake, whether it is too late in taking action. You have occasionally said that we must avoid tightening both too much and too little. Are you not running the risk of moving too late, inflicting undue pain?

I'll say it again: our macroeconomic projections are now in line with meeting the inflation target in the medium term. According to these projections, inflation will reach 2% by the midpoint of next year and will remain there for the coming quarters until 2026, which is the last year covered by this projection exercise. We can see that the upside and downside risks are balanced. At the ECB, we're aiming for a symmetric 2% inflation target now. This is one of the major innovations of the monetary policy strategy review that we approved in July 2021. This means that positive and negative deviations from the target are equally undesirable. This is why it's going to be very important to properly gauge the path for lowering interest rates in the coming quarters, such that we avoid tightening too much, but also too little.

Would you argue for lowering rates earlier?

We'll have to discuss that in April. Right now, though, the baseline scenario is as I mentioned earlier, if we meet expectations, and there is potential for surprises in either direction. Some analysts forecast lower growth in the euro area, which would drive faster deflation and they, therefore, think that the ECB should drop interest rates earlier or should even have done so already. Other analysts disagree, which is absolutely legitimate. But we have our own perspective. What's important is knowing how to react in a data-driven way and not cling unconditionally to any specific guidelines for monetary policy.

Have Spanish banks hindered the transmission of monetary policy by passing through ECB rate hikes more to lending than to deposits?

The evidence we have is that monetary policy transmission to credit conditions in the economy has been intense, both in terms of interest rates and lending volume. That said, there are some characteristics that are unique to the Spanish economy. These underlie the slower and lower pass-through to household deposits. It's also true that some credit segments have seen less pass-through of rises in policy rates. In any case, there are structural features in the Spanish economy that make overall monetary policy transmission faster than in other countries. This is, more than anything else, tied to the fact that variable interest rates continue to dominate among mortgages to Spanish households.

Is the dissatisfaction with the banking sector on account of it not passing through rate rises to deposits justified?

As I said, it is a fact that the Spanish banking sector has passed through interest rate rises to household deposits less than in other countries. At the Banco de España, we have looked into what's driving this phenomenon. One reason has to do with the excess liquidity and developments in lending. In the case of the Spanish economy (and also the Italian economy), there has been a notable slowdown in credit demand. Banks have not had to compete so much for deposits because of this more pronounced fall. That led to excess liquidity, broad-based in the euro area, being higher for Spanish banks and the pressure they were under

to pass rate hikes through to deposits being correspondingly lower. We also found a second reason. The level of bank consolidation in Spain rose, which, according to the empirical evidence we have before us, may also have played a role, although one that was quantitatively less significant than the first factor I mentioned.

Despite the monetary tightening, Spanish economic growth appears to be holding up better than that of the euro area. The Banco de España even revised up its forecast for 2024 this week.

Monetary policy is being transmitted to the economy forcefully. But monetary policy is only one of the factors that affect the economy. There are other factors and other economic policies, such as fiscal policy, that also play a role. The main reason for our upward revision to the forecast for 2024 is not that the dynamics in 2024 have changed from what we envisaged three months ago. Rather, it is because in 2023 Q4 the economy grew twice as much as we had forecast, above all due to the higher momentum of government consumption and stockbuilding, factors that will foreseeably lose steam in the coming quarters. But there are other variables, such as sluggish private investment, that point to economic growth being slightly weak. Private investment is yet to recover its pre-pandemic levels and this situation, if it continues, may have adverse consequences for the economy's future potential growth. Why then is the Spanish economy outstripping the euro area of late? First, Spain fell more during the pandemic, so the rebound effect is greater. Further, Spain has received sizeable migratory flows, of over one million people, since the onset of the pandemic. The tourism sector is also proving to be a major generator of economic growth. Spain has recovered its pre-pandemic level of real GDP similarly to other European countries over the last four years taken as a whole. But looking at real GDP per capita, Spain has diverged from the other European countries again precisely because of such buoyant immigration dynamics. This illustrates the Spanish economy's structural problems, in terms of both the higher rate of unemployment and low productivity. That's why applying the structural reforms needed to eliminate the roadblocks to greater prosperity is so important.

What role is political uncertainty playing?

When Banco de España surveys ask business owners about some of the concerns that are adversely affecting their activity, they have, for a few quarters now, stressed that economic policy uncertainty is their main concern.

This week saw a snap election called in Catalonia and the Spanish Government subsequently scrapping its plan to pass a budget for 2024. What impact could this political uncertainty have on economic growth, on the prospects for business investment?

I think all this further illustrates the current political uncertainty in Spain. With a highly fragmented parliament, it is proving very difficult to strike a consensus that would enable, for example, the budget to be passed. In any country the budget plays a key role in the design of the economic policy that will subsequently be implemented throughout the year. The lack of a budget confirms that the uncertainty perceived by the public, particularly business owners, and reported in the surveys, is real. Should this uncertainty persist, it could indeed end up adversely affecting economic growth. This is why it's important to reach a

political consensus on implementing the reforms and also on designing and applying the fiscal consolidation that the Spanish economy needs.

Will the failure to pass a budget for 2024 delay, for example, the roll-out of the European funds?

I don't know what the real economic impact is, but I imagine it will be hard for it not to have any at all.

Under the new fiscal rules, each country is required to submit a four or seven-year adjustment plan before 20 September. Do you think that's feasible, in the current political climate?

The need for an adjustment process – for a fiscal consolidation process that gradually reduces Spain's fiscal imbalances – is an absolute priority. We should address the vulnerability that such high debt and structural budget deficit levels pose. In addition, a new European framework, which is key to the euro area functioning smoothly, has just been adopted. Strict compliance with the framework is essential to its credibility. More than one parliamentary term will be needed for the fiscal consolidation process in Spain. Once again, a national consensus on this matter is essential.

What degree of adjustment to the budget deficit will the Spanish economy need to bear in each of the coming years under the new fiscal rules? The Independent Authority for Fiscal Responsibility (AIReF) calculates the necessary annual adjustment at around €10 billion. Has the Banco de España performed its own calculations?

The size of the annual adjustment depends on the period considered, which, under the new Stability and Growth Pact, can range from four to seven years. The AIReF's figures are, in our view, correct and would be consistent with a four-year adjustment plan. For a seven-year plan, which would need to be accompanied by investments and reforms, the average annual adjustment would be around 0.05 pp of GDP.

Do you think the criticism levelled at banks by society and politicians because of the increase in profits in the last two years is reasonable?

The Banco de España's obligation is to analyse in depth everything that happens in the banking sector, which we are entrusted with supervising. Bank profits are the sector's first line of defence against a potential economic crisis. They can bolster banks' resilience instead of them having to consume the capital buffers we require them to build up. Profitability in the sector has increased significantly in the last few years, after a long period of very low profitability. This increase is largely due to the growth in net interest income as a result of banks immediately passing through interest rate rises to their assets, but doing so less quickly in the case of their liabilities. However, part of this higher profitability will not be sustained over time because, among other reasons, an increase in defaults and credit risk is also foreseeable. This is why we, at the Banco de España, are asking the sector to heighten its resilience by using part of its current profits to raise its solvency ratios.

The two parties forming the Government have agreed to make the bank levy (which taxes revenue that in the coming years will foreseeably not remain on its current upward trend) permanent. What's your take on this?

I think drawing on the Italian experience is useful here. Should the Spanish Parliament decide to maintain this levy permanently, one way of easing financial stability concerns could be to give banks the possibility of deducting any additional contributions to reserves or capital. Basically, we would be incentivising the build-up of capital and therefore a more resilient banking sector. This is what they have done in Italy and it would be one way of making this measure compatible with strengthening the sector's solvency.

Have you had the chance to share this idea with the Economy or Finance ministers?

Yes, I have.

The twelfth anniversary of the intervention in Bankia will arrive in a couple of months. As a supervisor, are you comfortable with the public involvement, by the State, in a financial institution?

It was understood from the start that the State's presence in the bank had to be temporary. I think this criterion is still suitable. I don't think the public sector's presence in the banking sector can be easily justified from a structural standpoint. That said, the timing of the divestment needs to be chosen appropriately and this, of course, is the Government's responsibility. But I think the initial criterion remains valid.

Your term as Governor ends on 11 June. What are your plans after that?

Honestly, the job of a governor is very intense and it doesn't allow you to think about the day after. There are three months left and the most important thing is to continue doing things well and to finish the projects under way.

Do you see yourself in the private sector in the medium term?

I don't want to think about the future. Now is not the right time for that.

How about in politics?

I was asked this question some time ago and I replied I wasn't interested. I'm still not interested.

What profile should the new Governor have?

It is not my place to participate in this debate or discussion about the future Governor. I have always said that the Banco de España has two absolutely key pillars: independence and analytical rigour. And all of us at the Bank should behave in accordance with these two principles.

One of the names touted as a frontrunner for the position of new Governor is the current Deputy Governor, Margarita Delgado. Would she be a good option?

I'm not going to discuss this issue. The only thing I can say is that Margarita has been an excellent Deputy Governor and that we have formed a very cohesive team with a common set of objectives. I only have words of gratitude for her work.

Is it a good idea to maintain the traditional consensus between the two main parties when proposing candidates for the new Governor and Deputy Governor?

I think consensus in the appointment of those responsible for independent institutions is essential, precisely to reinforce the perception of independence and technical rigour. This is a long-standing tradition at the Banco de España and I think it is important that it remains so.

Traditionally, the government proposes the Governor and the opposition proposes the Deputy Governor. Is this correct?

Yes. But it is also important for everyone to understand that the two persons elected, regardless of who proposes them, have the technical ability and independence required.