Miguel Fernández Ordóñez: Overview of the Spanish economy in 2008

Address by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, to the Governing Council of the Bank of Spain on the occasion of the presentation of the Annual Report 2008, Madrid, 16 June 2009.

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Ladies and gentlemen,

The year 2008, the subject of the Annual Report I submit today to the Council, saw strains on international financial markets heighten and turn into a global financial crisis which ultimately triggered a widespread loss of confidence and an unprecedented worldwide economic recession.

The financial tensions pushed a large number of banks from a broad range of countries to the brink. And they have caused losses in the global financial system which, with all the due caution any estimate calls for, amount to trillions of euro. The crisis affected all financial markets, with some such as the asset-backed securities and interbank deposits markets brought to a grinding halt. The habitual stress indicators surged to all-time highs around October and remain at high levels despite the improvement in recent months. Clearly, the globalisation conducive to the growth of finance in recent years has also been instrumental in the swift and simultaneous spread of tensions, seeing them extend further.

Testifying to the real impact of the financial crisis in all its harshness was the contraction of over 6% in the world economy at end-2008, and the decline in world trade of more than 20%, both in terms of annualised rates, with most of the more advanced countries in full-blown recession and with growth in the emerging economies dwindling substantially. The picture worsened further in the first quarter of 2009, marking what currently appears to have been the crisis at its height. The improvement in the latest indicators suggest contractionary forces are abating, and the danger of a continuous deepening of the recessionary spiral appears to have been allayed.

A real and financial crisis on the scale currently attained reveals deep-seated weaknesses that affect the structural interlinkages of economic systems. In principle, the severity of the crisis depends on the magnitude of the shock that triggers it and on the strength of the economies on which it bears down. Evidently, from this perspective, the increase in US subprime mortgage defaults, the bankruptcy of Lehman Brothers and any episode that may now be singled out could not alone have triggered a situation of the seriousness and on the scale that we have seen. Rather, such episodes preyed on economic and market structures that were fragile and that had incubated unsustainable trends which could not be detected or corrected in time.

With hindsight, it was clearly a mistake to assume that financial markets had virtually unfettered capacity to improve risk management, and to have given excessive leeway to self-regulation. Further, the continuous expansion of spending in some advanced economies on the basis of growing private debt was a key component of the so-called “global imbalances”, about whose dangers many reports warned. But the detection of the problem did not suffice either to properly diagnose its potential scope or to act accordingly. Indeed, economic policies – and monetary and financial policies in particular – were, broadly speaking, clearly excessively lax during the upturn.

Economic authorities now face the challenge of designing appropriate mechanisms to strengthen institutions in their economies and, once the crisis is behind us, to prevent such trends from recurring.

This challenge firstly involves a far-reaching review of some of the basic principles underpinning financial market regulatory and supervisory policies in recent years. A new balance must be struck between regulation and self-regulation, providing both financial institutions and other investors with appropriate incentives to curb the natural tendency of financial systems to accentuate business cycles. It will also be necessary to extend the purview of regulators and supervisors, avoiding the presence of “blind spots” in financial systems, and seeking a suitable response to the fact that markets and many market players are increasingly more global, both in terms of the geographical scope of their actions and of the products they trade. The crisis has also highlighted the advisability of designing and setting in place a macro-prudential supervisory framework concerned with overall stability and which thus complements individual bank-focused microprudential supervisory conduct.

Macroeconomic strategies should likewise be reviewed in light of the shortcomings they have evidenced, in order to detect and correct in time the imbalances I referred to earlier. In the case of fiscal policies, greater emphasis on the sustainability of public finances in the medium and long term would have provided a more powerful countercyclical component to offset excessive private-sector spending. As regards monetary policy strategy, careful analysis should be made of the role to be played by the identification and appropriate coverage of risks to stability that originate, develop and, in the worst-case scenario, materialise in financial markets.

Fiscal and monetary authorities also share the substantial challenge of designing “exit strategies”. These allow, once the crisis has been overcome, for the winding down of the various measures that central banks and governments have adopted in the face of the risk that this crisis might bring the world economy to the verge of a depressive spiral with grave consequences.

The raft of measures adopted has been wide-ranging, and many are based on common principles jointly agreed upon in different international fora. Multilateral cooperation is crucial for successfully tackling a global crisis. Further headway must thus be made along these lines, harnessing opportunities such as that provided by the G20 meeting in London last April. Not in vain, one of the lessons to be drawn from past experience is that economic redeployment behind national borders and protectionism are sure-fire recipes for exacerbating and prolonging global crises such as the present one.

Among the measures adopted, central banks in the advanced economies reacted decisively by providing abundant liquidity to financial systems and substantially cutting their key interest rates. These standard monetary policy measures were later complemented by other, non-conventional measures. The European Central Bank began very early to increase liquidity assistance and, from October, banks’ applications for liquidity began to be met in full, while the range of financial assets accepted as collateral for these operations was widened. The main refinancing rate has been cut by 325 basis points to an all-time low of 1% following the May meeting. And, as regards extraordinary measures, the term over which liquidity is injected has been extended to 12 months, and funds are provided in currencies other than the euro, thanks to cooperation agreements with other central banks; the European Investment Bank has been granted the status of eligible counterparty, in order to smooth the course of the loans this institution makes to European SMEs; and the decision has been taken to purchase covered bonds and other similar types of asset-backed bonds. At the same time, an expansionary monetary impulse of unprecedented proportions was set in train in Europe, commensurate with the seriousness of the contractionary trends experienced in the real and financial domain.

At government level, measures were aimed, first, at supporting financial systems and, further, at stimulating demand. Among the former, selective bail-outs of banks of systemic importance in the opening months of 2008 were followed, after the heightening of tensions in markets as from the summer, by the raising of deposit guarantee scheme limits, government-backed bank issues, public injections of capital and the purchase or the safeguarding of the value of troubled assets held by banks. All these measures were under the umbrella of the common principles for concerted action, at the level of the Heads of State and of Government in Europe, and at the G20 meetings more globally.

Among the demand-stimulus measures, and aside from the operation of the automatic stabilisers, which are pivotal in economies such as Spain, measures based on increased public spending and aimed, on many occasions, at the groups and sectors most adversely affected by the crisis, tended to predominate. The European Economic Recovery Plan approved in December provides the reference point here for the coordination of measures in Europe.

The Spanish authorities have also adopted a broad set of similarly geared measures. These include the raising of the limit on deposit guarantees, the creation of the Fund for the Acquisition of Financial Assets to purchase high-quality assets from Spanish banks, guarantees for bank bond issues, various special financing facilities instrumented through the ICO (Official Credit Institute), and the introduction of new personal income tax deductions and the launching of the State Fund for Local Investment and of the Special State Fund for revitalising the economy.

In Spain, the international crisis has impacted the economy at a particularly delicate time. Already under way was a process of adjustment of the imbalances that had built up over a long growth phase in which Spain had shared some of the above-mentioned factors of fragility of the world economy, though not all of them and not to the same degree of intensity. Certain components were undoubtedly particular to Spain.

Starting with the shared elements, the expansion of Spanish household and corporate spending was based excessively on debt. True, the private sector was starting from relatively low debt levels. Admittedly, too, euro area membership provided a particularly valuable framework of stability and broadened financing possibilities. No less true, however, was the fact that the single monetary policy stance proved overly lax during all these years for Spanish domestic conditions and that fiscal policy, even though substantial budgetary consolidation was undertaken, was not enough to offset the excessive monetary looseness. A greater containment of current spending in the upturn would have helped curb the imbalances and would have strengthened the underlying budgetary position.

Other features of our expansionary phase were, however, more specific. In Spain, productive factors and financial resources were overly concentrated in the real estate sector. Further, some of the structural constraints of our economy, such as productivity and the functioning of the labour market, did not show sufficient improvement.

Another singular factor has been the position of relative strength from which the Spanish financial system has faced the crisis. Spanish banks continued to pursue a “traditional” business model during the entire upturn, focusing on retail financial intermediation. This is certainly the main reason why, as is widely known, the role of Spanish intermediaries in the generation, acquisition and financing of toxic assets has proven negligible. As the system’s supervisor, the Banco de España also contributed to entrenching this relative strength, through a policy that focused on the cyclical pattern of building up provisions and on the rigorous definition of the scope of consolidation of financial groups.

The Spanish financial system was thus able to ride the first wave of the crisis – the nature and origin of which, let me remind you, were strictly financial – and readapted its sources of funding to the new market situation. Loan securitisation therefore left centre stage to deposits, short-term commercial paper issues and bank resort to the new abundant liquidity provision policy implemented by the ECB for the whole of the Eurosystem.

Nonetheless, the transformation of the financial crisis into a real recession has given rise to a second wave of risks to financial stability, whose nature is this time eminently macroeconomic. The Spanish financial system is facing this second wave with the relative advantage of having been less damaged by the first. But that is no guarantee of immunity since the deterioration of the Spanish economy exerts pressure, through various channels, on banks' and savings banks' income statements. I shall discuss this when I turn to the financial system, after having analysed the situation of and outlook for the Spanish economy.

The Spanish economy did not escape unscathed from the global contractionary trends, and in 2008 it underwent a far-reaching adjustment. Declines in GDP were evident from the third quarter, leading the economy to post a 0.7% fall in output at year-end in terms of its year-on-year rate. This recessionary pattern became more visible in the first quarter of 2009, when GDP decreased at a year-on-year rate of 3%, while employment was down 6% on its level a year earlier. As at world level, the improvement since in the latest indicators appears to point to some easing of the contractionary trends.

The adjustment of the Spanish economy is impacting particularly those domestic spending components which showed the greatest excesses during the long upturn. The origin of this behaviour lies in the overlapping of a series of differing shocks. Firstly, the correction of the real estate sector and of the high level of private-sector debt, which had started prior to the crisis, already entailed significant elements of spending containment. Further, however, the forceful effects of the international financial crisis and of the global recessionary trends compounded this situation, amplifying the contraction of domestic demand, eliminating any possible external support and exacerbating the loss of confidence. This latter factor was, moreover, particularly affected by the impact of the far-reaching deterioration of the labour market on income expectations, an important matter which I shall return to later.

As a result of these factors, there was a marked decline in Spanish household spending, both on consumption and on residential investment. In 2008, both items accounted jointly for 80% of the decline in the contribution of national demand to output, which stood at slightly more than 4 pp for the year on average. Naturally, the heightening of the financial crisis in the final stretch of the year, and the subsequent deterioration in macroeconomic expectations, saw the contractionary impulses spread to the other components of domestic spending, meaning that business investment ultimately collapsed in the second half of the year. Indeed, the sole prop of spending in 2008 was net external demand, which showed a marked increase with a contribution of 1 pp to GDP growth for the year as a whole and of 2.3 pp in the final quarter. Set against the progressive weakening of the world economy, this improvement in the external contribution was due to the notable slowdown in imports, whereby the fall in GDP is proving more moderate than in other countries.

The decline in residential investment, along with the sharp pick-up in the household saving rate to 13% of disposable income, entailed an abrupt reduction in household net borrowing, insofar as households generated a net lending capacity for an amount equivalent to 0.6% of GDP over the year as a whole. The slowdown in household debt intensified to the extent that the debt/GDP ratio began to fall in the closing months of the year. In the case of businesses, the decline in productive investment also led to a sharp reduction in net borrowing, which was ultimately manifest in a slowdown in the rate of increase of the debt ratio, although the interest burden still continued to increase.

As a result of the change in the sign and intensity of foreign trade, there has been a reduction in the nation's high net borrowing, which stepped up in the opening months of 2009, as shown by the 25% decline in the first quarter when compared with the same period a year earlier. Foreseeably, the decrease in the external deficit will continue apace in the coming months, and it may have halved within two years, evidencing the speed of the adjustment induced by the depth of the contraction in domestic demand.

On the supply side, the weakness in activity passed through to all productive branches, but with particular force to construction and industry. Employment was rapidly eroded following fourteen years of uninterrupted job creation. In late 2008 and early 2009, job destruction was most intense and, since the labour supply remained notably strong, the unemployment rate surged to 17.4% in the first quarter of the year, bearing down most on the young and the lesser skilled.

Regrettably, this high unemployment figure shows that one of the risks I referred to when presenting the *Annual Report for 2007* has materialised. I insisted then on the need to prevent the adjustment of the Spanish economy from falling predominantly on employment, as in previous recessions, since that would have significant adverse multiplier effects on demand and activity, via disposable income and future income expectations. And as stated, this is proving precisely to be one of the most powerful channels for the propagation of contractionary trends. One of the traditional behavioural patterns of the Spanish economy is thus recurring, revealing the persistent weaknesses in its institutional framework and arrangements that must be corrected.

The high increases in labour costs witnessed last year, reflecting the rise in inflation in the first half of the year, were not favourable to employment. Wage cost pressures have only begun to abate in 2009, in line with improved inflation expectations, following the declines in the rate of change of the CPI in recent months.

Indeed, after inflation had moved on a markedly rising trend in the first half of 2008, prices slowed sharply in the closing months of the year as a result of the abrupt turnaround in oil and food prices and of the marked sluggishness of demand. This deceleration has become more pronounced in 2009 to date, with the annual rate of change of the CPI falling in March, April and May (-0.9% in this latter month). While the CPI trajectory reflects the correction of some price rises in the most volatile components in the opening months of 2008, the ongoing recession, which is severely affecting consumption, is prompting an adjustment in prices and margins that is beginning to impact services and the other less volatile components. And this means that the price growth differential with the euro area has turned negative, and will foreseeably remain so in the coming months.

The CPI is expected to continue to temporarily post negative rates of change in the coming months and, once the statistical effect linked to higher oil prices in the first half of 2008 is stripped out, inflation should resume positive although very moderate rates of change. This price behaviour is in line with the improvements in competitiveness required to lessen the scope and costs of the recession, to prompt the necessary adjustments and to embark on a sound recovery.

The outlook for the Spanish economy points to declines in GDP over the rest of the year that should lead to a significant fall in 2009, albeit slightly lower than is forecast for other European countries. It is highly likely that the worst of the contraction has already passed, and that the intensity of the restrictive impulses will begin to diminish in the second half of the year as the broad range of measures implemented progressively deploy their effects. As a result, the fall in activity in 2010 is expected to be less pronounced. The course of employment in this scenario, in any event, is a cause for concern; despite the somewhat more positive signals given by some recent indicators, linked in part to seasonal factors, job destruction may run for some time and the unemployment rate may continue further on its rising trend.

The imbalances built up during the long expansionary phase, in the form of the inflation differential and the resort to external financing, are being swiftly reabsorbed, providing an unquestionable source of relief in the global outlook described. Yet this rapid correction is occurring on the back of an excessive brake on activity, entailing major costs in terms of job destruction, higher unemployment and the deterioration of the productive fabric. If the institutional features behind these developments are not reformed, there is a risk that, even after the most acute phase of the crisis is over, they will continue to hold back the Spanish economy's possibilities of recovery and become a drag on further progress in real convergence with Europe.

To rebuild sound foundations for growth, economic policy should contribute to setting in place the appropriate conditions to revive confidence, to return financing flows to normal and to reinvigorate spending plans. That will require headway in restoring health to the financial position of the private sector and the banking system, the completion of the adjustment in the real estate sector and, above all, improvements in productivity, competitiveness and job creation incentives.

The correction in the construction sector is proving most intense. And although there is still a sizeable stock of unsold housing, the reduction in interest rates and in house prices will no doubt make the residential market more accessible. Cheaper borrowing terms and the easing of credit restrictions will also help breathe new life into spending. But it will be the recovery in external demand, as we move out of the international crisis, that will act as the main support. And the more competitive national production is, the more powerful this effect will be. To this end, and as frequently indicated by the Banco de España, sustained increases in productivity must be attained and the pertinent cost, margin and price adjustments made.

The scale of the global recession called for the implementation of demand-side expansionary fiscal and monetary policies. And it is in this context that the substantial cuts in central bank intervention rates seen over the past year should be understood, cuts that have been conducive to a significant decline in the cost of financing and to a sharp expansionary stimulus. In Spain, the potential effects of this pass-through are particularly powerful as a result of the prevalence of floating interest rate loans.

Spain, too, has moved to adopt demand-stimulating discretionary fiscal measures in order to bolster the expansionary impact of the substantial transfers of income to the private sector, especially to households, arising from the operation of the automatic stabilisers. The fiscal drive by the Spanish authorities is of a considerable scale and generally exceeds that of other developed countries. Its budgetary impact has been accentuated, moreover, by the sharp fall in tax revenue as a consequence of the economic recession and of the magnitude of the real estate adjustment; accordingly, the fiscal situation has deteriorated rapidly.

It should be recalled that the Spanish economy started from a healthy budgetary position, with a surplus of somewhat over 2 pp of GDP and a very low public debt ratio compared with our European counterparts. Indeed, at last year's presentation of the Annual Report to the Council, I referred to budgetary policy as one of the main underpinnings of the Spanish economy in this phase of the cycle and I pointed out that the favourable fiscal position would allow the automatic stabilisers to operate to their full extent without jeopardising budgetary stability.

One year on, the fiscal results for 2008 and the projections available – which point to a budget deficit approaching 10% of GDP in 2010 and to a public debt ratio that might exceed the threshold of 60% of GDP – augur a drastic change in outlook, with the possibilities of fiscal policy boosting spending having been exhausted.

Fiscal measures that call into question the commitment to budgetary stability in the medium term should be categorically avoided, since that would adversely affect the cost of raising funds and confidence in the Spanish economy, and it could also generate expectations of future tax rises that might ultimately sterilise the expansionary effects of the measures adopted. Public-sector debt must be prevented from becoming an obstacle once the Spanish economy is better placed to grow. Accordingly, priority must be given to promptly defining a credible strategy to reduce the deficit to levels compatible with budgetary stability, once the exceptional circumstances that led to the rise in the deficit have disappeared.

The demand-side expansionary fiscal and monetary impulses are proving very powerful and are contributing to the alleviation of the contractionary forces at play. Evidently, though, the possibilities of further using these types of policies have become notably constrained, both at home and abroad. It should also be borne in mind that, once the economic and financial fragility beleaguering the world economy has been resolved, demand-side policies should adopt a more neutral stance.

All these considerations on the diagnosis of the Spanish economy in the current international crisis and on the limited leeway available to demand-side policies mean, rather, that economic policy has a central role to play in implementing the reforms that help improve productivity and the behaviour of the factor and product markets. It is in this area that the authorities undoubtedly have effective room for manoeuvre, and also considerable responsibility.

Let me begin with the labour market, which is where the most pressing problems are to be found. The scale of job destruction has once more highlighted the existence of distortions that emerge with force in recessions and compound contractionary trends. And there is a risk that, as in the past, the surge and change in level in unemployment may stick and that this will delay subsequent recovery. Labour market dysfunctions are also closely linked to the discouraging behaviour of the economy in respect of gains in economic efficiency and in productivity, hampering the possibility of attaining genuine improvements in competitiveness and of raising growth potential. Economic recovery in Spain requires structural changes that will encourage technologically dynamic productive sectors with high growth potential to take up the baton from construction. For this to occur, the labour market must function so as reallocate resources, increase and adapt workers' skills to new demands, and make productive processes within companies more efficient.

Reform should focus on ensuring that labour conditions adjust to the economy's different cyclical junctures and, in particular, to the specific circumstances companies or productive sectors face. That should prevent the adjustment coming about through pushing large numbers of workers out of the market. Changes are also needed in hiring arrangements. These must allow workers who have lost their jobs to return promptly to active working life, so they do not spend long periods unemployed, the consequences of which were so adverse in the past. Improvements in labour market intermediation systems and in mobility and training for the unemployed are also very important.

Resolute action here would help check business closures and lessen the risk of decapitalisation, which is admittedly very high at present. If, moreover, significant progress were made in eliminating administrative formalities, the Spanish economy would be better placed to resume a high growth rate once the world recovery began.

To bring about a new productive pattern enabling high rates of potential growth to be regained, structural measures must span a wide range of fields. Improving the level of educational attainment of the labour force is vital for raising the quality and productivity of human capital. Decisive and effective action in boosting the knowledge economy should contribute to substantially increasing technological capital and to bridge the gap blighting the Spanish economy in this area. And improving the competitive environment in which businesses take their decisions is crucial if all these steps are to result in overall gains in efficiency and competitiveness. One key area for progress along these lines is liberalisation in the services sector, which encompasses some of the most dynamic activities with the greatest employment-generating capacity and where new forms of labour relations may be more successful. Further, the growing interaction between industry and services has increased the influence of the latter in determining international competitiveness. It is likewise necessary to continue pushing through liberalisation and competition in the network industries, so that the conditions in which inputs are provided to other productive activities allow Spanish companies to compete on an equal footing with other developed countries. The liberalising impulse must be regained, in particular, in the energy, telecommunications and rail transport sectors.

I shall devote the final part of my address to analysing the situation of the Spanish banking system in greater detail.

An economic environment marked by a real and financial global crisis poses a first-order challenge to the normal pursuit of banking activity. As stated, the first wave of shocks, confined essentially to the financial arena, did not have appreciable direct effects on our banks, and the indirect effects were absorbed in an orderly fashion. However, as from last autumn a second wave of shocks was unleashed, resulting in a real global crisis which, naturally, is impacting Spanish banks.

The Spanish economy's entry into recession has consequences for banking and bad debts. In particular, such repercussions include those arising from the high sensitivity of employment – and, therefore, of households' ability to pay – to the deterioration in activity, and those from the adjustment of the real estate sector, the relative weight of which in bank balance sheets had become significant.

The deterioration in the economic situation reduces the demand for credit of bank customers, whose spending plans and income expectations are normally revised downwards during economic downturns. Likewise, banks become more cautious about granting loans as a result of the subsequent upward revision of the risk profile of borrowers. In combination, these two factors translate, as we have actually seen, into a substantial slowdown in bank credit. Based on the past cyclical behaviour of this variable, the growth rate of bank credit will tend to stand below that of GDP. This cyclical component of credit is currently being reinforced by the difficulties still besetting wholesale funding markets and by the need both in Spain and in the rest of the international financial system to redress the high levels of leverage attained in the past.

The behaviour of banks' bad debts also follows certain cyclical patterns. Defaults increase when, as now, the deterioration in activity weakens the financial position of bank customers, particularly in the case of households whose members lose their job. Thus, following a long economic boom that brought doubtful assets ratios to historically low levels, the year 2008 saw a sharp rise in such ratios, and the persistence of difficulties in the real sector of our economy suggests that pressures have not yet dissipated. This is a risk that banks must be mindful of and manage appropriately.

The diminished pace of activity and the increase in bad debts, which are general trends across Spanish banks and savings banks, exerted pressure on their income statements already in 2008. The recurring income inherent in a traditional banking model, which is therefore less reliant on financial market developments, explains why, despite the difficult economic circumstances, bank results were positive, in clear contrast to those reported by many of the institutions in other developed countries' banking systems.

But Spanish banks' results will come under considerable pressure in the future. In the short term, as a result of the foreseeable increase in bad debts. In the medium term, because competition for funds will squeeze operating margins and this pressure will not be readily offset as it was in the past by the generation of higher volumes of business. And I do not believe that the ongoing deleveraging of the financial sector, and of the economy in general, taking place both in Spain and globally, should be viewed as transitory. Nor does it seem feasible that further substantial contributions of private capital will be forthcoming if the tensions on international financial markets do not subside.

From an overall perspective the Spanish system is in a position to overcome all these challenges, though as I have reiterated, talk of immunity is completely out of place. Indeed, not all banks are in the same position when it comes to coping with the tensions. This is because they have pursued different lending policies over recent years in terms of the rate of expansion of loans and of the degree of risk concentration. Even among banks that have followed similar strategies, notable differences can be identified regarding the selection of specific risks, their ability to manage them and the buffers, in terms of profitability and solvency, available to them to alleviate the effects of any risks that may materialise.

For all these reasons banks should make the changes necessary to adapt to the new circumstances. These changes unavoidably involve stepping up efforts to rationalise operating costs and to correct the overcapacity in the sector which arises from a worldwide tendency towards lower levels of leverage.

This overcapacity in the banking industry should be tackled through restructuring processes that allow a sound and efficient financial intermediation system to take root. Such a system is a strength of the Spanish economy which should be preserved so that, once the crisis is behind us, a sustainable growth path underpinned by the efficient allocation of all resources, including financial ones, may be resumed.

This central role of a financial intermediation system explains why the State has, in addition to other support measures I have previously discussed, shown its readiness, like other governments, to provide capital to viable credit institutions that need it. These contributions, or any other assistance, must nevertheless be conditional upon the restructuring of the institutions that receive these public funds, so as to seek both the lowest cost for taxpayers and maximum efficiency. This approach squares fully with the common principles agreed upon in the international fora of which Spain is a member, and which have been backed expressly by Parliament with a broad consensus. Hopefully, these principles and this spirit of cooperation in matters relating to the stability and resilience of our financial system may soon result in a series of legal provisions that reinforce the ability to deal with potential problems, in line with the tradition of the Banco de España and in keeping with the specific nature of the tensions we are currently experiencing.

Cooperation, in this case among international authorities, will also be necessary to further the design of the new, globally applicable guiding principles for the working of markets and financial – banking and non-banking alike – intermediaries. Earlier I referred briefly to the significant challenges emerging in this area. Allow me succinctly to review some of the work and recommendations under way in different fora to palliate the structural weaknesses highlighted so starkly by the current crisis and to lay the foundations for a new and more solid international financial structure.

From the banking regulation perspective, the Basel Committee on Banking Supervision is entrusted with implementing the recommendations made by the Financial Stability Board, along with the plan of action that arose from the November 2008 G20 meeting, which was subsequently ratified at the April 2009 meeting. The work programme the Basel Committee has set itself covers various areas, including most notably the improvement of asset risk assessment and management by banks, the adjustments needed to the eligibility of capital instruments, the new requirements for liquidity risk, and matters concerning transparency and market reporting.

In the supervisory domain I should like to highlight the so-called Larosière Report, drafted by a group of high-level independent experts which was set up on the request of the President of the European Commission. Their mandate was to draw up proposals for improving supervisory arrangements in the European Union. Included in the group was an ex-Director General of our institution. The Report contains 31 recommendations whose ultimate aim is to reduce the likelihood of a crisis such as the present one recurring and, should it recur, to ensure its costs are minimal. I shall focus, however, only on those recommendations bearing directly on the structure of financial supervision in Europe in its microprudential and macroprudential facets.

As regards microprudential supervision, the Report proposes the creation of a European Financial Supervision System. Under this system, the current Level 3 Committees for banking, insurance and securities would be transformed into three European supervisory authorities with the power to take binding decisions in certain fields.

As to macroprudential supervision, the creation of a European Systemic Risk Board was proposed. Its main purpose would be to detect general risks, apprising the competent European authorities thereof, where pertinent, so they might take the appropriate decisions.

These are some of the initial steps of a process which will no doubt be long, but which will profoundly affect the systems of each and every European country. It is thus important that Spain should participate actively in the work of these international fora. In this respect, it is most satisfying that Spain has been welcomed as a member of the Financial Stability Board, the successor of the Financial Stability Forum created in 1999, in which we had not hitherto participated. To be sure, the Banco de España's experience in the design and implementation of a regulatory and supervisory system that has proven most effective during this crisis has been one of the factors that have helped Spain merit this position.

And here I shall conclude, though not without first thanking the Governing Council, the Executive Commission, the Directors General and all our staff for their work this year. I should like to single out two people to thank: José Viñals, who has been with me at the helm of this institution over the past three years, and Javier Aríztegui, who has replaced him and assumed the key post of Deputy Governor of the Banco de España. I can safely say that, thanks to everybody's efforts, the Bank has been able to creditably perform the tasks entrusted to it. As stated in my address today, new major challenges will arise in the coming months, linked closely to the emergence from the exceptional situation experienced by the markets and financial institutions over the past two years, and these will no doubt affect the core functions the Bank has to perform. I am sure I can count on the support of all of you to tackle them satisfactorily.