Miguel Fernández Ordóñez: Presentation of the 2011 Annual Report

Address by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, to the Governing Council of the Bank of Spain on the presentation of the 2011 Annual Report, Madrid, 8 June 2012.

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Ladies and gentlemen,

The presentation of the *Annual Report* for 2011 is taking place in an extremely difficult setting for Europe in general, and for Spain in particular, marked by the acute euro area sovereign debt crisis and the double-dip recession in the Spanish economy.

The year 2011 was characterised by the worsening of the euro area sovereign debt crisis. Initially affecting a small number of countries in a situation of relative vulnerability, it spread to others with sounder economic fundamentals, duly turning systemic. The fresh downturn in the euro zone not only detracted from the area's recovery but was also one of the main determinants of the halt in the ongoing pick-up in world growth begun a year earlier.

Two main factors lay behind the crisis. First, the insufficient adaptation of domestic economic policies to the demands of monetary union membership, which translated into a build-up of major imbalances that placed some economies in a position of vulnerability. And second, the lack of political consensus at the European level to tackle the weaknesses of the euro's institutional design, which largely explains the spread of the tensions to countries whose misalignments were on a lesser scale.

Throughout 2011 and in 2012 to date, positive steps have been taken. Several countries have launched ambitious fiscal adjustment programmes and undertaken banking system recapitalisation and restructuring processes. And structural reforms in the labour market and in the services sectors have been approved. Also, on a Europe-wide scale, debt-ceiling monitoring mechanisms have been reinforced, as have the procedures to sanction non-compliance. Further, under the new Treaty on Stability, Coordination and Governance, there have been moves to promote the explicit recognition of the commitment to budgetary stability in national legislations. Along with this progress in the fiscal realm, a new framework has been established to prevent and correct macroeconomic imbalances. This Excessive Imbalance Procedure, as it is known, should be instrumental in the early detection of vulnerability and in setting in place the necessary corrective measures. With the establishment of the European Stability Mechanism, there has likewise been headway in creating a permanent crisis-management mechanism.

In sum, there has been significant progress. But frequently these changes have, as the markets say, been "behind the curve"; their implementation has been excessively slow and they have been subject to too many frictions, which has fuelled investor doubts over the ability of European governments to move forward and forge consensus on matters pivotal for governance in the area.

Under these conditions, ECB action has been decisive in preserving stability in the area. When debt market tensions reared again in the second half of 2011, the ECB reacted with various measures. These were geared to confirming the expansionary stance of monetary policy, to restoring the functioning of its transmission mechanism and to breaking the feedback loop between banking system risks and sovereign risk. In addition, significant non-conventional measures were approved. These included most notably the lengthening of the horizon for liquidity loans to a term of three years, in two special auctions held in December 2011 and February 2012.

The three-pronged measures adopted – spanning domestic economic policies, European governance reform and, most notably, ECB action – proved essential in containing the heightening tensions, which might have led to a systemic crisis of unforeseeable consequences. That said, these measures were not a conclusive solution; they simply helped gain valuable time so that governments could continue moving to resolve the challenges outstanding and so that the measures adopted might begin to bear fruit.

To definitively resolve the European sovereign crisis will require major progress in various fields. In the short term, the ongoing reform of governance must be completed and put into practice, including the full start-up of the European Stability Mechanism. A suitable balance must also be struck between two complementary objectives: fiscal consolidation and economic growth. Here, the "fiscal package" agreed at the end of 2011 must be supplemented with a new "growth package".

Looking more into the medium term, profound reflection is needed on the euro area we want in 10 years' time. This crisis has highlighted the vulnerabilities that may emerge in a monetary union lacking common fiscal and financial policies. It is thus worth considering a greater transfer of sovereignty in these areas.

On the home front, the challenges the Spanish economy faces are enormous. The latest episode of the sovereign debt crisis is severely impacting agents' confidence and the economy's financing conditions, placing it in a position of extreme vulnerability. Following two consecutive quarters of negative growth, our economy is once again in recession and the prospects of recovery are not immediate. Moreover, the prolonged cyclical weakness is preventing swifter headway in redressing public finances and in reducing private-sector debt, and casting doubt on the resilience of the financial system. That has triggered tensions on the debt markets and activated perverse feedback loops.

Lastly, the Spanish economy risks seeing its capacity to obtain external funding severely blocked. While in the short run this does not actually constrain ordinary funding flows (given the banking system's possibility of resorting to ECB funding), the prolongation of such a situation will be extremely harmful in the medium term.

Spain is in this situation despite the fact that its authorities have implemented far-reaching reforms in recent years to resolve the inefficiencies in its economic functioning, to correct the serious deterioration in public finances and to redress and restructure the financial system, in order to restore financing flows.

Resolving these problems is taking longer than expected, but that should not lead to reform fatigue. It is important to persevere with the economic policy actions undertaken. In this way the levels of competitiveness needed to ensure the smooth functioning of the euro area may be regained, the ordinary funding channels restored and the imbalances built up in recent years, in particular in relation to public finances, finally corrected. These requirements must be met if the economy is to begin to generate employment and to grow.

The adjustment continues to fall on domestic demand, weighed down by the correction of imbalances, the fiscal consolidation drive and tighter financing conditions. The external sector continues to soften the impact of domestic spending on activity, due both to the buoyancy of exports and to the slackness of imports from the rest of the world, but its contribution is insufficient to halt the decline in output.

In this setting, job destruction continued apace in 2011 and in 2012 to date. And, owing to the uncertain prospects for the Spanish economy, a turnaround is not expected in the very short term. However, as this episode is progressively overcome, the approved labour market reforms will foreseeably have a favourable impact on employment generation, contribute to adjusting working conditions to firms' specific circumstances and provide for a more efficient reallocation of productive resources, which should ultimately prompt an increase in productivity levels.

The cyclical weakness and the adverse behaviour of the labour market have not fed through sufficiently to the cost and price-formation mechanism, which still shows considerable inertia. The adjustment of unit labour costs is being achieved primarily thanks to the high productivity gains brought about by job destruction, while the easing in inflation has corrected to a lesser extent the gap built up during the upturn.

This behaviour highlights the slow and imperfect functioning of the competitiveness channel, which should in principle lead to a containment of prices and costs in those economies that accumulate bigger external misalignments. Indeed, achieving lasting improvements in competitiveness requires greater cost and price adjustments and productivity gains associated with genuine improvements in productive efficiency.

However, since 2007 the Spanish economy's external deficit has been substantially corrected, dipping from 10% of GDP in 2007 to 3.4% of GDP in 2011. Underpinning this narrowing of the deficit has been the buoyancy of exports and the sluggishness of imports, in step with the weakness of domestic demand. Notwithstanding, the culmination of this adjustment is conditional upon certain elements such as the deficit on the energy balance and the magnitude of the investment income payments component, with a negative balance equivalent to 2.7% of GDP in 2011, which is very closely related to the high level of the International Investment Position. These factors all accentuate the importance of those reforms contributing to correcting the deficit through the boosting of sustainable competitive gains in the medium and long term. The correction of this imbalance is particularly pressing in that the reliance on external saving has become a major factor of vulnerability of the Spanish economy during the crisis.

The increased dependence on external financing in the pre-crisis period is the consequence of the sizeable accumulation of debt by households and firms, which also led to the Spanish banking system becoming oversized. The need to correct these imbalances poses an added difficulty to recovery in the economy, given that it restricts the headroom available to raise investment and consumption through resort to external financing.

It is also crucial to continue with the restructuring of the banking system. Hence, when solvent demand recovers, it may be serviced by a normal flow of financing which, both in Spain and in the rest of continental Europe, is routed essentially through credit institutions. But households and firms still have a relatively lengthy process of debt reduction ahead of them. Accordingly, in the short term, the recovery in growth cannot be credit-led as in the past.

Along these lines, credit to the non-financial private sector in 2011 fell by around 4%, although there were significant differences from sector to sector. In the case of households the pace of debt reduction was somewhat slower, whereas in that of firms the reduction in credit was more marked in those sectors, such as construction and real estate development, that had become oversized to a greater extent before the crisis. In contrast, the need for adjustment is less in those large corporations whose growth has largely been based on increased geographical diversification.

All the foregoing factors will influence the pattern of exit from the recession. The need to reduce debt levels will, coupled with fiscal consolidation demands, continue to limit the possibilities of expanding domestic spending, meaning that the recovery should turn on net external demand. At the same time, it is necessary to begin to reverse the dynamic of external debt, which will require further progress in attaining a more balanced foreign trade position, overcoming the obstacles posed by the high investment income component and the dependence on energy imports.

A pick-up in competitiveness will thus be pivotal if external demand is to stand in for the shortcomings of domestic demand and boost growth on the supply side, which in the current circumstances is the only way forward.

To overcome the crisis an economic policy geared to the medium term is needed to help complete the correction of the macroeconomic imbalances still in place, to further the restructuring of all sectors and to allow the structural reforms outstanding to be tackled.

Fiscal consolidation is unavoidable if growth in the medium term is to be restored, despite the fact the scale and timing of the adjustment required may have adverse effects in the short term. This is the only strategy available for restoring market confidence. Compliance with the objectives set requires rigorous budgetary implementation, to which all levels of government should contribute. The strengthening of the budgetary framework under the recent Budgetary Stability Law should assist in this connection. The law sets explicit ceilings on deficit and debt levels in line with demands at the European level, and it includes stricter reporting requirements and new coercive mechanisms to ensure compliance by all tiers of government with fiscal targets.

The fiscal consolidation strategy should also take into account the medium and long-term considerations affecting public finances, in particular those associated with population ageing, namely spending on pensions and health care.

Lastly, it should be said that the weakness of the labour market and of growth have been the main factors behind the limited progress in correcting the budget deficit in 2011. Without a recovery in employment and in growth, it will be costlier in the long run to pursue fiscal consolidation, so boosting structural reforms must be a priority. Among these, promoting so-called *flexicurity* to the full is vital, and should be complemented by a fresh liberalisation drive in the markets for goods and services that is conducive to competition, training in new technologies, innovation and the improvement of human capital.

Another key economic policy priority should be to continue with the ongoing clean-up, recapitalisation and restructuring of the Spanish banking system. Since 2009, the measures in this area have adhered to a set of common principles, although changes in economic conditions and in the markets have meant governments have had to adjust them. These principles include most notably to limit as far as possible use of public funds and to minimise the length of time the State has a stake in the banks; to promote integration and restructuring processes to counter the excessive fragmentation and size of the sector; to pursue the clean-up of bank balance sheets to withstand asset quality impairment; to reinforce bank solvency; to resolve the structural weaknesses of the savings bank model, and to promote transparency.

Among the measures adopted in 2011 to which the *Annual Report* refers is Royal Decree-Law (RDL) 2/2011 on the strengthening of the financial system. This legislation raised core capital requirements to 8% generally, and to 10% for unlisted banks with a high dependence on wholesale funding, which were those on which doubts were greatest. To ensure that all banks could meet these requirements, it was decided that the Fund for the Orderly Restructuring of the Banking Sector (FROB) should act as a backstop. Further, the RDL stipulated the obligation for those institutions requiring public aid to operate as banks, with the aim of reinforcing their fund-raising capacity, and transparency towards investors. These measures, along with pension reform, contributed most positively to the easing of market tensions witnessed in the first half of 2011, with the risk premium falling at one point below 200 bp.

Following the approval of the RDL, the banks and the authorities focused on ensuring compliance with this legislation, and on pursuing bank integration processes and on implementing the business model changes arising from the amended regulations governing savings banks. Under the provisions of the RDL, 13 banks had to increase their capital by more than €13 billion, meaning that in the second stress test conducted by the European Banking Authority, further capital increases were not needed. However, as the crisis worsened and spread in summer 2011, the Community authorities demanded a temporary increase in the capital requirements of large banks and the creation of a temporary extraordinary buffer associated with potential sovereign debt portfolio losses. These new requirements were applied to the five largest Spanish banks, for which additional capital needs of somewhat over €26 billion were calculated.

As a result of all these developments, there was significant progress in the clean-up and restructuring of the Spanish banking system. From the onset of the crisis to the beginning of this year, provisions of around 13% of GDP were set aside, banks shored up their solvency by significantly increasing their capital, most savings banks converted into banks and around 30 institutions disappeared, with their management passing in most cases to other sounder and more efficient banks. As regards the sector's capacity and the size of banks, staff and office numbers fell by around 12%, standing at similar figures to those as at end-2004, and the average size of banks in terms of their assets increased twofold.

Yet this progress was not enough to restore investors' confidence in the soundness of our banking system. Given the double-dip recession, the insufficient reduction in the budget deficit and the continuing effects of the sovereign debt crisis, doubts persisted about the quality of construction and real estate development-related assets.

In an attempt to dispel this uncertainty, various measures were adopted in the first half of 2012. Furthering the principles that have governed the ongoing restructuring of the financial system, the measures addressed accelerating the clean-up of bank balance sheets, reinforcing their solvency, boosting integration processes and promoting transparency. RDL 2/2012, approved in February, stipulated an increase in provisioning for construction and real estate development-related assets, and the creation of a capital buffer to cover potential losses arising on problem loans associated with land and ongoing developments. More recently, in May 2012, the Government approved RDL 18/2012, on the clean-up and sale of financial-sector real estate assets. The aim was to dispel doubts over the quality of Spanish credit institutions' non-doubtful real estate portfolio. To do this, provisions for construction and real estate development-related assets not classified as troubled have been raised substantially, bringing forward the impact of potential additional impairment to this portfolio. Banks that undergo a capital shortfall as a result of these new requirements will have to reinforce their capital, resorting to financial aid from the FROB if necessary.

Overall, the clean-up and capital increases arising from the two RDLs approved this year will see a considerable reinforcement of the banking system's buffer against potential losses. Indeed, once these measures have been fully implemented, the provisions set aside by the Spanish banking sector since early 2008 will amount to close to 19% of GDP. In addition, the legislation demands problem foreclosures be transferred to asset management companies, and a programme for private appraisers to value the entire credit portfolio of the banking sector has been set in train.

Allow me to conclude with some reflections on two issues I consider very important: the restoring of confidence, and the importance of independent regulatory agencies.

In the difficult circumstances facing the Spanish economy, the most critical variable is neither growth nor unemployment, no matter how serious recent developments have been, but rather the deterioration in confidence. The priority aim of action by all authorities should be to restore lost confidence, since without it resuming growth and job creation will not be possible. The low level of confidence we have hit in recent months and weeks means that resolving Spain's fiscal and financial problems has become more difficult and costly.

The potential impact on confidence should, therefore, be a primary determinant of any action by the authorities, political representatives and economic agents. Here a particular effort should be made to explain all the decisions adopted by the different levels of government in Spain that have been well-received and valued by the markets, such as structural reforms, pension reform and the recent Organic Law on Budgetary Stability, among others. There should likewise be a common effort, in the interest of all sectors of the Spanish economy, to disseminate and address in depth the additional measures that should shortly be adopted to tackle the crisis. There is no more important or pressing task in the short term than to restore lost confidence. And here, collaboration is called for by politicians and economic and social agents in positions of responsibility, and by all institutions with economic policymaking responsibilities.

A fundamental determinant of confidence is the credibility of regulatory and supervisory institutions, based on their ability to exercise their powers professionally and independently. This is always an essential element of a country's economic reputation, but all the more so when confidence has been called into question and the recovery in growth depends on the external financing of its economy.

Adam Smith observed in his famous work that the wealth of nations was then closely related to how open their trade was. And today we can see how the richest and most democratically sound countries in the world are those that have competent and independent regulatory and supervisory agencies that act as a counterweight to governments potentially succumbing to interventionist temptations.

Internationally, it is currently accepted that governments have very important tasks to perform in the financial field. These may include designing restructuring strategies, determining resolution instruments, deciding on the use of public funds, etc. But there is also broad consensus that such tasks should be implemented by independent regulators and supervisors.

By assigning the regulatory and supervisory remit to independent institutions that act using sound technical criteria, the danger of decisions being subject to the vagaries of politics or to lobby group interests is removed to some extent. Reasons of technical capability also come into play. Independent and professional supervisors have the time and resources to build up enormously rich knowledge which, given the particular characteristics of financial activity, is essential for tackling problems in this sector, minimising errors and unwanted side-effects at the same time.

Having independent regulatory and supervisory institutions by no means guarantees that mistakes are not made. But their presence ensures that decisions are not tainted by momentary political considerations. I cannot say that the Banco de España, in its supervisory mission, has not occasionally been mistaken. But I can assure you that the decisions of the Banco de España have always been based on exclusively professional criteria.

This is an important facet of independence. Independence is not something innate. It is not a label or badge conferred by anyone. Independence is demonstrated, and it is exercised or not exercised. Nobody is independent for what they are, but rather for what they do. But another important aspect to ensure the independence of these institutions is to prevent governments or interest groups affecting such independence. In the specific case of the Banco de España, the respect of the authorities for its independence and reputation is crucial for maintaining confidence in our banking system at home and abroad, and for overcoming the major challenges we currently face.

Naturally, this respect for the independence of regulatory and supervisory agencies should unavoidably be accompanied by an obligation on their part to account for the performance of their functions before Parliament. Such accountability to the representatives of the nation should not only be an obligation for these agencies but also their right, since the transparency provided by Parliament is a mainstay for safeguarding the independence of the institution from possible interference by authorities and interest groups.

Allow me to thank those here, the Deputy Governor, the Governing Council members and the Directors General, and all the Bank's staff for their collaboration these past six years. I deeply recognise the competence and dedication with which they discharge their important responsibilities.

But I should like to conclude expressing my particular appreciation of those who have participated in the supervisory function of the Banco de España these past years. Banking Supervision, Banking Regulation and our Legal Services have been involved in major actions affecting the most vulnerable institutions, such as, for instance, removing most of the managers from 30 credit institutions, converting savings banks into commercial banks and assessing numerous clean-up and recapitalisation plans, and complying at all times with the mandate of different governments to minimise the use of taxpayer funds. It is telling that the image (measured by their ratings) of our major banks has systematically been above that of the world's 23 biggest banks throughout the crisis until, in recent weeks, a downward spiral of downgrades has ensued and doubts about our banking system as a whole have spread. But this is no time for despondency. I am convinced that, once time puts everybody in their place, your work during these years of crisis will be acknowledged and rightly appreciated by all.

Thank you.