Luis M Linde: Assessment of Spain's economic situation

Testimony by Mr Luis M Linde, Governor of the Bank of Spain, before the Parliamentary Committee on Economic Affairs and Competitiveness, Madrid, 17 July 2012.

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Ladies and Gentlemen,

Every year the Governor of the Banco de España appears before this Committee to give an assessment of the economic situation, as part of the presentation of the Bank's Annual Report.

The backdrop to today's appearance is one of great difficulty and, therefore, of great importance. The Spanish economy is undergoing difficult economic circumstances and the problems our public finances and banking system face are a focal point of interest for national and international investors, analysts and policymakers. I therefore believe that, changing the usual emphasis of the presentation of the Report, there are grounds to devote an extensive part of my address to the important and pressing problems of our financial system and to the measures for redressing them.

My presentation is therefore structured around four areas:

- International economic developments.
- The situation of and outlook for the Spanish economy.
- Developments in our banking system following the outbreak of the international crisis in 2008.
- The plans to clean up, reform and strengthen our banks' solvency and operational capacity.

1 International economic developments

I should first point out that the process of recovery in the world economy, begun in 2010, has come unstuck in 2012. We are currently experiencing a further bout of weakness in global activity that is affecting the most developed economies and the euro area, but also the major emerging economies.

1.1 The euro area

The sovereign debt crisis, initially confined to a limited group of economies, evolved over the course of last year to become, first, a systemic crisis for the euro area as a whole, and later, a cause for concern and a factor of risk for the global economy.

The roots of the current crisis must be sought in the build-up of imbalances in different countries' public finances. The crisis has highlighted the fact that the institutional arrangements underpinning the euro and the common monetary policy have cracks and inconsistencies that must be repaired, and the political difficulties regarding how to set about such repair have contributed to exacerbating them.

Admittedly, there has been progress in the field of domestic economic policies and in the management of the area as a whole. In the countries affected by the most serious tensions (Greece, Portugal and Ireland), ambitious fiscal consolidation and reform programmes have been set in train. Reforms include both those undertaken in the markets for goods and factors and those addressing banking systems. The common monitoring and early-warning mechanisms and those, where necessary, for the correction of macroeconomic – primarily fiscal – imbalances have been strengthened and extended, and a European mechanism for crisis management and the provision of financial support to Member States in difficulty has been designed: first, and temporarily, the European Financial Stability Facility and later, and permanently, the European Stability Mechanism.

In recent months, several principles have been laid down to improve economic cohesion among the European Union countries, structured around four major courses of action: an integrated financial framework at the European level; greater fiscal integration; greater co-responsibility in the design of economic policies; and advances in transparency and accountability geared to strengthening the legitimacy of the entire process.

But, irrespective of these medium- and long-term measures, it must be said that a major part of the task of stabilising the euro area has fallen on the European Central Bank, both with conventional monetary policy measures, and with non-conventional measures involving the purchase of member countries' sovereign debt. There is a debate on the role of the ECB, as to whether it has been sufficiently resolute or expansionary; but it should in any case be acknowledged that its provision of long-term liquidity and its debt purchases have been positive measures.

According to the International Monetary Fund, the growth outlook for 2012 is negative for the euro area countries as a whole (–0.3%), and points to very scant growth for 2013 (around 0.7%).

1.2 Other developed economies and emerging countries

The euro area sovereign debt crisis has adversely affected the other advanced economies, thus compounding the contractionary impulses (such as the tsunami in Japan and its implications for the nuclear industry, and the political tensions in the Arab countries) and the short-term effects of the adjustments under way to reduce private-sector debt levels, to redress financial systems and to scale back oversized real estate sectors. The United States grew by 1.7% in 2011, compared with 3% in 2010; the United Kingdom posted growth of under 1% in 2011 and Japan fell back by 0.7%.

The emerging economies, however, were more resilient to this contractionary current and grew by 6.4% over the year as a whole. The uptrend in commodities prices, capital inflows and the continuing dynamism of the Chinese economy helped explain these developments. That said, the global context of growing uncertainty, the slowdown in world trade, induced by the diminished dynamism of the developed economies, and the contractionary monetary policies implemented in these countries to combat the risks of overheating all exerted an effect which was felt, above all, in the second half of the year.

2 The crisis of the Spanish economy

I shall now turn to the Spanish economy.

The Spanish crisis has a home-grown component, whose origins lie in the expansionary phase that followed the 1992–1993 crisis and which ran until the outbreak of the current crisis in the summer of 2008. During this expansion, severe macroeconomic and financial imbalances built up, essentially a marked deterioration in competitiveness and excessive debt.

Heavy corporate and household debt (routed through Spanish credit institutions which, in turn, had to resort to external borrowing to obtain the funds needed) left the Spanish economy potentially exposed to the global financial instability and to the instability of the euro area.

The extraordinary expansion of the construction and real estate sector played a decisive role in this process of over-indebtedness, since a most sizeable volume of financing was required. The pattern of expansion in this sector prompted other misalignments, such as the episode of acute overvaluation of real estate assets and an oversized construction sector. The outcome of these developments was the most severe real estate crisis the economy has witnessed in recent decades, which triggered the recession in Spain.

The impact of the real estate adjustment on employment and activity was particularly marked in the initial stages of the crisis owing to the intensive use of labour in construction and to the knock-on effects on other productive sectors, a feature common to other developed economies with a similar set of problems.

Our public finances benefited during this stage from exceptional revenue growth (I refer to the years from 2003 to 2007), which detracted from the effort to contain domestic demand. This all took place, moreover, in very accommodative financial conditions, i.e. with very low or, indeed, negative real interest rates at times, owing to the policy then pursued both by the US Federal Reserve and by the European Central Bank. This growth in public revenue would ultimately prove unsustainable, meaning that the recession resulted in a serious fiscal crisis, precisely when events in Europe would lead analysts and the markets to focus on the sustainability of public finances.

The Report stresses that this situation requires an economic policy that redresses the financial position of all sectors – households, firms, general government and financial institutions – and corrects the malfunctioning of certain institutions which hamper adjustments and affect competitiveness.

The three pillars that should underpin this economic policy strategy are an ambitious process of fiscal consolidation and public saving; the pushing through of reforms to enhance efficiency and competition in the sectors least exposed thereto; and, of course, the restructuring and reform of our banking system and its regulations.

Among these reforms, mention should first be made of that of the labour market. For many years, practically all international economic agencies and analysts across the ideological spectrum have repeatedly signalled the problems of our labour market, its adverse effects on job creation and what the broad thrust of reform should be. Understandably, there are discrepancies on aspects of the reform; but there is no doubt that our old labour market model was very inefficient and required reform.

The Annual Report of the Banco de España explains how the heightening of the sovereign debt crisis and its interaction with the financial system situation plunged the Spanish economy into a double recession, both in 2009 and 2012. At issue is an extraordinary event, for which there are no precedents in our economic history, and which renders notably more complex the correction of the imbalances in our public finances owing to their dual impact, hindering any increase in revenue and favouring an increase in expenditure.

The forecast of the Banco de España is for a decline in GDP of 1.5% in 2012 as a whole. But, on the positive side, it should be pointed out that our economy is undergoing an adjustment of already appreciable intensity. We will conclude 2012 with a current account almost in balance, with fairly favourable prices (our inflation rate remains below the euro area average) and with developments in wages that will make the course of unit labour costs compatible with an improvement in our competitiveness. Evidently, some of the adjustment in the current account balance is attributable to low economic activity, but only part of it. There is also an improvement in competitiveness.

3 The situation of our banking system

Now to our banking system, and the developments in recent years and its current situation.

Our banking system is undergoing difficulties whose origins must be sought in the long period of expansion that began in the mid-1990s and ran until early 2008. This was a period in which credit to the resident private sector increased at an annual average of 15%, a rate which quickened in the final stretch of this period, rising to average figures of 23% between

2004 and 2007. The gross debt of households and non-financial corporations rose from 107% of GDP in 2000 to 201% in late 2011, when this same ratio stood at around 165% both in the euro area as a whole and in the United States (although in the United Kingdom it was at 207%).

This accumulation of debt by the private sector led to an increase in the Spanish net debit position vis-à-vis the rest of the world, which stood in 2011 at 92% of GDP. This figure is close to that exhibited by Greece (before the haircut), Portugal and Ireland (all of them around 100%). Countries such as France, Italy, the United Kingdom and the United States showed net debit positions against the rest of the world of between 10% and 20% of GDP. At the other extreme, Germany and the Netherlands have net asset positions in relation to the rest of the world of around 35% of their GDP.

Turning to the asset side of bank balance sheets, the growth in credit was not balanced across the various sectors of the economy, but was concentrated mainly in the real estate sector. As a result, exposure relating to real estate purchases, development and construction came to account in 2007 for 62% of financing to the resident private sector.

This progression in lending portfolios could not be funded through natural growth in resident retail customers' deposits, which is the most stable base of financing; rather, increasing resort was made to wholesale and interbank markets, which provided at that time abundant liquid resources at reasonable prices, but which, on the other hand, exposed banks to very high risks of liquidity and rollover costs, risks that many Spanish banks were not accustomed to managing.

As a result, the scale of real estate risk and of the dependence on – largely foreign – wholesale funding markets turned into two sources of vulnerability which became patent with the crisis as from 2008.

3.1 Measures adopted in the 2008–2011 period

The international financial crisis began in mid-2007 in the United States, from where it spread to the economies and financial systems of the developed countries as a whole.

In Spain, the first measures were adopted in October 2008. The Fund for the Acquisition of Financial Assets was set up and a public guarantee mechanism was approved to facilitate new issues of bank paper, with the aim of tackling the difficulties progressively emerging on the interbank market and which were affecting the wholesale funding of certain banks.

Next, also in 2008, the coverage of deposits guaranteed by banks, savings banks and cooperatives was raised to an amount of €100,000, as was then the case in certain other European countries.

In 2009 the FROB (Fund for the Orderly Restructuring of the Banking Sector) was set up to provide public aid to integration processes between credit institutions, defining a new resolution framework. This initiative allowed, or promoted, a series of mergers and integrations between savings banks, whose number declined from 45 to 17 institutions or groups at the end of 2010.

An important piece of legislation, Decree 11/2010, was enacted in 2010 to tackle the two main limitations facing Spanish savings banks: their inability, or the impossibility for them, to raise capital on the markets and their governance problems, opening the way for them to pursue their financial business indirectly, via banks, a formula which rapidly became widespread.

Also in 2010, measures were adopted in relation to accounting for provisions, tightening the treatment of foreclosed assets and of real estate collateral, and shortening the provisioning schedule for doubtful loans; a policy of greater transparency in the so-called "stress tests", conducted under the coordination of the European institutions, was pursued; and the Banco de España required banks to increase the information they provided on their real estate development and construction loans and on their retail mortgage portfolios.

In early 2011, further to Decree-Law 2/2011, capital requirements were increased for Spanish credit institutions, with a new minimum capital – so-called "core capital" – ratio being set at 8%, which was raised to 10% for banks highly dependent on wholesale markets. This same Decree-Law offered FROB backing to those banks that could not attain the new minimum obligatory levels by their own means, through new aid arrangements that opened the way for the FROB to take up capital stakes in banks.

In October 2011, the three deposit guarantee funds of banks, savings banks and cooperatives were unified, with the possibility for this new fund to participate in the financing of restructuring operations managed by the FROB.

3.2 Measures adopted in 2012

Although the problem dated back further, as earlier stated, the figures on our financial system clearly indicate that there was a most sizeable increase in our total gross and net debt from 2003 to 2007. That affected the economy as a whole and, in a country where the prevalence of banks is as great as it is in Spain, the debt was channelled essentially through the banking system.

Despite the measures adopted from 2008 to 2011, doubts over the viability of a segment of our bank and savings bank system were not dispelled, and indeed heightened in 2011 and early 2012. The worsening international economic picture and the slide by our economy towards a fresh recession naturally contributed to this situation, which was primarily centred on the accounting valuation and treatment of the mass of assets related to real estate risk.

Evidently, however, we cannot attribute all responsibility for the downturn in confidence in our banking system to the international economic situation, to the problems of the euro area (in particular, the situation in Greece and the negotiations on its bail-out which have had an unquestionable and strong impact, as the European Central Bank itself has acknowledged on several occasions) or to our recession.

I am going to move on now to an area which I am well aware is delicate and where I risk being misinterpreted. But it is an aspect I do not wish to sidestep or avoid. I wish to make some observations on events in our financial system from the standpoint of the supervision and responsibilities of the Banco de España.

In the real estate and financial bubble years that ended in 2008, there was a sort of euphoria, not only in Spain but in all the European Union countries and in the United States, which led to the risks that were accumulating to not be seen, or not wish to be seen. It was as if nobody wanted to forecast scenarios of recession, interest-rate rises or collapses in funding.

Merely by way of illustration I am going to highlight three issues on which, I insist, with the ready lucidity hindsight offers, and, of course, without seeking to teach anybody a lesson, we can conclude that actions were taken with little resolve or insufficiently and inappropriately.

Firstly, the "Institutional Protection System" mechanism, the so-called "cold mergers", a means of integration which sought to avoid or circumvent the political difficulties posed by regional governments, and other difficulties posed by the banks themselves, in the face of savings bank merger and integration processes that were deemed advisable. "Cold mergers" were accepted with the aim of promoting certain processes that could allow the sector to be rationalised and improve the efficiency of specific savings banks; clearly, however, their final effect was not very positive and contributed rather to delaying decisions and adjustments.

Another example lies in countercyclical provisioning, which the Banco de España was obliged to abandon, if not in full, at least in part. The Banco de España was, indisputably, a pioneer in the introduction of this measure which would be classified today as a macroprudential policy tool. At the time, the measure was criticised by the international financial community because it was not readily compatible, it was said, with accounting rules and because it ran counter to the separation of macro and regulatory policies then advocated. And it was also criticised, we should recall, by Spanish banks, since it was understood that it damaged or could damage their competitive position.

From today's standpoint, many would agree that the main shortcoming of that regulation was its timidity and its insufficiency to rein in excessive credit growth, and that we would all have come out winning had it been maintained and applied across the board, as the Banco de España had argued at the start of the new millennium, and had it been made even more demanding. In sum, the Banco de España was considered to be unorthodox at the time. But today we know that it should have been even more unorthodox in using its regulatory and supervisory powers to mitigate the vulnerability of our financial system.

Further, and this is the third point on which I should like to like to comment, I believe that practically nobody foresaw the double-dip recession. This event undoubtedly affected the quality of the stress tests conducted by the Bank in 2010 and 2011 under the exercise overseen by the European Banking Authority.

In short, and judging past events with the information we have at hand today, the Banco de España was admittedly unsuccessful in what we now call "macroprudential supervision". We failed to tackle, with the resolve we now understand would have been necessary, the considerable increase in our debt and, later, the heavy deterioration in bank balance sheets, the outcome of the bursting of the bubble and the recession. The fact we are not the only European supervisor that can be reproached on this is of no consolation to anybody.

That said, I would now like to move to the beginning of the current year, 2012. The two Decree-Laws passed in February and May have involved adopting a more radical approach to tackling actual or potential non-performing assets on banks' balance sheets, and to cleaning up and restructuring a significant portion of our banking system.

The first of these decrees, in February, focused on problem loans, stipulating extraordinary provisioning requirements for loans classified as doubtful or sub-standard, irrespective of the value of the attendant collateral, and for real estate foreclosures or assets received in payment of debt. In addition, in the case of problem loans with a greater risk profile, such as land and developments in progress, a capital buffer was required to safeguard banks against potential extraordinary losses. Moreover, banks had to set aside a provision of 7% for the portfolio of loans considered performing or normal.

The second decree in May took a further step and sought to resolve doubts over assets in a normal or performing accounting situation, by increasing the provisions required on the basis of the nature of the assets financed. In sum, average provisions were increased from 7% to 30%, with greater penalties for land-financing and unsecured exposures.

The overall effort for credit institutions resulting from the two decree-laws, which must be completed in the current year, 2012, amounts to around €59 billion worth of provisions and €11 billion in respect of capital buffers.

With this fresh effort, the Spanish banking sector will, from 2007 to 2012, have made write-downs exceeding €200 billion, to which must be added the increase in core capital requirements (the above-mentioned €11 billion). Overall, that entails an effort equivalent to more than 20% of Spanish GDP in 2011.

4 External assessment and agreement with the Eurogroup

A complex set of circumstances has influenced the deterioration of confidence in the Spanish banking system: the adverse performance of the international economy; the euro area crisis; the absence of an improvement in public finances in a group of countries including Spain; and, of course, the market perception that our banking system was not resolving its problems of non-performing assets and real estate asset impairment.

Given this situation, in May the government took two decisions: 1) to undertake an independent assessment of the degree of solvency of the Spanish banking system, as a whole, and of its business outlook; and 2) to obtain financial aid from our European partners in order to implement a plan for the restructuring and recapitalisation of our banking system.

Regarding the first of these measures, you will recall that an agreement was reached with two independent appraisers and four auditors to estimate Spanish banks' capital requirements in two recession scenarios, one a severe recession, from 2012 to 2014. The results of this initial assessment were made public on 21 June and showed initially that the Spanish banking system, as a whole, might need between €51 billion and €62 billion in order to maintain a capital ratio of 6% in a very pessimistic macroeconomic scenario which, in short, means a cumulative fall in GDP of 6.5% between 2012 and 2014.

This initial examination should be completed with two further exercises to be performed by the end of September, which will involve a detailed analysis of the balance sheets of 14 banking groups, the classification of assets, the provisions recorded and the valuations which have been taken into account, in order to determine the recapitalisation and provisioning needs of each of the institutions studied, which will account for more than 90% of the Spanish banking system.

The entire assessment and audit exercise has been, and will be, coordinated and monitored by committees on which the European Commission, the European Central Bank, the European Banking Authority and the International Monetary Fund – in addition, of course, to the Ministry of Economic Affairs and Competitiveness and the Banco de España – are represented. The agreement reached between the Spanish government and the Eurogroup will be, firstly, in the form of a Memorandum of Understanding that will be signed on 20 July and followed by other agreements to develop and implement it.

The actual use of the funds may only be specified when the exercise has been finished in its entirety, i.e. when the bottom-up exercise and the monitoring by appraisers has ended. However, the general criteria for using the funds, which will be included in the Memorandum of Understanding are already known and I shall briefly summarise them.

An initial group of banks will meet the new core capital references envisaged in the exercise without the need for recapitalisation measures. It is no secret that the major banks in the Spanish financial system have demonstrated their solvency, their loss-absorbing capacity under stressed situations and their ability to generate high levels of capital within the business. Accordingly, it can be assumed that, together with other smaller institutions, they will be in this group. In short, the exercise will confirm that a significant portion of our banking system is in a position, without the need for public aid, to maintain all of its activity and to contribute efficiently to the channelling of our economy's financial flows.

There is a second, pre-defined group of institutions comprising banks which have been taken over or are managed by the FROB: BFA/Bankia, Catalunya Banc, NCG Banco and Banco de Valencia. We can readily anticipate that the biggest needs for capital arising from the exercise will be at these banks.

A third group of banks will include those with additional capital needs which, in terms of amount and the position of the institutions, may only be met by having recourse to the public aid envisaged in the European financial assistance programme.

Finally, a fourth group of banks will include those which, without reaching the required capital levels, propose in their recapitalisation plans adequate measures to raise private capital within a moderate period of time. If the additional capital required is high, it is reasonable that they should provisionally receive a temporary injection of public funds in the form of contingent capital.

Those are the details for banking groups. However, the Memorandum of Understanding also contains procedures and targets, which I will summarise in five points.

1. The aid lent to each bank shall entail compliance with a series of conditions, the broad framework of which has been negotiated by the European and Spanish authorities. The ultimate aim is to cement the long-term capacity and resilience of our banking system and to generate the confidence needed for it to regain normal access to the markets.

2. The banks receiving public aid shall have to undergo restructuring compatible with European regulations on State aid. Logically, the stringency of the restructuring plans will have to be commensurate with the volume of aid envisaged and will be geared to strengthening the banks' capacity to maintain a sustainable and profitable business. The restructuring may result in adjustments in size, the elimination of unprofitable business segments, the rebalancing of funding structures, improvements in governance and the rationalisation of networks.

3. Should an institution be deemed not to be viable, it will be wound up in an orderly fashion, as has occurred with certain institutions throughout this crisis, such as Caja de Castilla La Mancha, CajaSur, la Caja de Ahorros del Mediterráneo and Unnim.

4. Two of the principles that will underpin the recapitalisation and restructuring of a portion of our banking system will be the separation of troubled assets (the vehicle that we have taken to calling a "bad bank", although it may not be a bank but an asset management company); and the participation of shareholders, creditors and taxpayers in general in the clean-up and restructuring costs:

   a The segregation of troubled – mainly real estate – assets continues and further pursues an avenue opened up by our legislation with Decree Law 18/2012, which envisages the segregation into separate companies of assets acquired in payment of debt, thereby definitively removing impaired assets, foreclosures and bad loans from the balance sheets of banks receiving public aid. It is a technique tested in other countries such as Sweden, Ireland, the United States and Germany. It is a vehicle or entity for concentrating those assets for their subsequent management and sale, by "cleansing" the balance sheets of institutions and permitting, should they be viable, their valuation and ensuing disposal.

   b In relation to the equitable distribution of costs, the agreement will include the need to minimise the burden for taxpayers through measures which may affect, among others, the payment of dividends, remuneration of bank managers and directors and the commitments undertaken by holders of instruments qualifying as capital other than shares.

5. The Memorandum will envisage a series of measures applicable to all Spanish banks. These measures will focus on the requirement of a capital ratio of 9% and will include improvements in: resolution regulations, the treatment of risk concentration, the role of savings banks as shareholders of banks, the transparency of financial information, supervisory procedures, the marketing of complex products and the Central Credit Register, among other aspects.

The recapitalisation plans submitted by banks must be realistic and capable of being implemented in the short term; otherwise, the institutions will have to demonstrate their viability, undergo restructuring and receive public aid. Were any institution not sufficiently robust to guarantee its future existence, it would have to face an orderly process of resolution or winding up. Management of the mass of impaired real estate assets of institutions receiving aid will be extended over time, albeit separately, without impinging on banks' operations and results.

The core of our banking system is essentially healthy and I am sure that soon, with the implementation of the current programme, our banks will pursue their activity with the solvency and vitality needed to fulfil their main mission: efficiently intermediating financial flows and contributing to economic growth.

We have a financial system with banks that rank among the most efficient under any international comparison. I believe that we will all take to heart the lessons learned , which are very painful from various standpoints, and that our financial system will emerge from this crisis strengthened and more efficient. It will again be the cornerstone it has always been for economic progress and the well-being of our people.

Thank you very much for your attention.