Luis M Linde: Overview of Spain's economy in 2012 – reflection and outlook

Testimony by Mr Luis M Linde, Governor of the Bank of Spain, before the Parliamentary Committee on Economic Affairs and Competitiveness, Madrid, 20 June 2013.

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Ladies and gentlemen,

I appear before this Committee on the occasion of the presentation of the Banco de España Annual Report for 2012, one of the most difficult years for the Spanish economy of the last decades.

I shall begin with a review of the general economic situation, and then focus on the progress achieved in restoring the major balances of our economy, developments in credit and in household and corporate debt, the headway in balance sheet clean-up and restructuring of our banking system, financial regulation reforms and progress in the European Banking Union project. I shall conclude with a reflection on the outlook for our economy.

Situation of and outlook for the Spanish economy

Throughout 2012 the Spanish economy held on the contractionary course that first became discernible in late 2011. GDP fell by 1.4% during the year, far above the 0.5% decline recorded in the euro area as a whole. This double-dip recession, the second dip of which is less acute in terms of the decline in output but more persistent than its 2008–2009 forerunner, has had particularly serious consequences for employment, which shrank for the fifth year running in 2012.

The main macroeconomic and financial figures for 2012 speak for themselves as regards the intensity of the adjustments made in an attempt to overcome the serious imbalances that emerged during the last upturn.

The fall in household income, prompted above all by the heavy decline in employment, along with high household debt, continued to exert a contractionary effect on spending capacity against an overall background of uncertainty. Once again in 2012, companies, many of which are immersed in deleveraging and financial restructuring processes, cut their investment, while the adjustment in the construction sector continued. Meanwhile, the general government sector tailored its spending plans to the need to reduce the budget deficit, following the serious budgetary slippage evidenced at the close of 2011.

All these factors combined to bring about a strong decline in national demand, which was only partly offset by the positive contribution of the external sector. Imports fell forcefully, mirroring the weakness of final demand, while exports expanded despite the poor performance of the euro area markets, to which Spain still directs half of its foreign sales.

However, developments to date in 2013 appear to confirm that the worst of this second recession is behind us. The biggest declines in output were at the end of 2012, and the latest data suggest the contraction in GDP is easing. Indeed, in the final stretch of the year, and even from the third quarter onwards, positive growth rates might be recorded.

Fiscal consolidation

Significant steps were taken last year to reduce the budget deficit and strengthen the budgetary discipline and management framework.

In the first of these areas, and although both expenditure- and revenue-side measures were applied, it should be stressed that the bulk of the effort consisted of spending cuts, allowing net overall general government borrowing to be reduced to 7% of GDP, or 10.6% when the assistance (a non-recurring expense) to financial institutions is included.

Last month the European Commission announced a new fiscal consolidation path, setting new deficit targets of 6.5% and 5.8% for the current year, 2013, and 2014, and of around 4% for 2015, and requiring that the 3% threshold laid down by the Stability and Growth Pact be met in 2016. The additional margin provided will help soften the short-term contractionary impact of the fiscal adjustment on activity.

As to public spending discipline and management, I should first mention the April 2012 Organic Law on Budgetary Stability. This legislation implements the principles of limiting the structural deficit and volume of debt that were enshrined in our Constitution in 2011.

The Law makes key improvements in terms of the transparency of public finances. Many of these improvements were set in train in 2012 and early 2013. In terms of the availability of data on general government financial and budgetary conduct, Spain now probably stands at the head of the European Union countries.

To highlight the most significant improvements, the Stability Law firstly sets minimum reporting requirements for regional and local government, including monthly revenue and spending outturns for regional governments, and quarterly ones for local governments, along with the information needed to calculate the budget outturn in National Accounts terms.

Moreover, since June 2012, the IGAE (National Audit Office) has been regularly publishing quarterly accounts of all general government sub-sectors in National Accounts terms, on an individual basis for regional government and in aggregate terms for local government.

Also, since October 2012, the monthly regional government accounts have been regularly published in budgetary accounting terms and, since March 2013, in National Accounts terms. Further, from last March, monthly National Accounts figures on Central Government and on the Social Security System began to be released, complementing the monthly State data in National Accounts and cash-basis terms, and the monthly Social Security System data in cash-basis terms that have been published for more than three decades.

Apart from these reporting improvements, the Stability Law includes mechanisms to correct slippage in budget outturn. The Independent Fiscal Responsibility Authority, whose creation is scheduled for the end of this year, will complete this new governance framework.

The pension system

The sustainability of the pension system is pivotal to the medium- and long-term soundness and stability of public finances and to the very credibility of any consolidation programme for total public spending. This is an area where substantial measures have already been adopted, but in which it is vital to maintain the thrust of reform.

Our current Social Security pension system is contributory and unfunded, and will necessarily have to continue being so. It is a fundamental factor of economic and social stability, meaning that it is in everybody's interest to address the risk of shortfall, which is essentially due to demographic developments. To be sustainable, the system must be able to properly control its key elements, such as retirement age, the calculation of pensions and the so-called "sustainability factor", which is currently being defined. It is welcome news that practically all the political forces are working in the spirit of the Toledo Pact which was approved almost 25 years ago and has repeatedly received the support of our Parliamentary institutions.

But it is imperative to point out that, in the long run, the potential of the unfunded system to ensure retirees will enjoy a standard of living in step with the levels of income achieved in their working life may be limited. Accordingly, supplementary capitalisation formulas must be explored to allow more scope for saving during working life. These supplementary systems, of which there are examples in different countries, may be private but also public. In any event, as it takes a long time for any drive of this nature to mature, it is also in everybody's interest to set about studying and putting in place the necessary arrangements as soon as possible.

Progress in correcting the external imbalance

It is in the external sector where the swiftest and sharpest correction of imbalances is being made. The adjustment in the external sector continued in 2012 and, as a result, after posting a surplus in the second half of the year (an unprecedented development since the launch of EMU), the current account was practically in balance, with a deficit of only 0.2% of GDP for the year as a whole. Current forecasts point to surpluses on the current account for 2013, 2014 and successive years.

In addition to the contraction in imports attributable to the fall-off in domestic spending, this performance reflects the restoring of the competitiveness lost by the Spanish economy during the expansion that ended in 2008. By late 2012, two-thirds of the gap built up since 2000 between Spanish unit labour costs and those for the euro area on average had already been corrected. These gains in competitiveness have been accompanied, in the most recent period, by notable growth in the number of exporting firms and by greater geographical diversification of our exports, with an ever-increasing weight of those targeted on emerging markets.

Competitiveness and market reform

To put the favourable external sector performance on a firm footing, we must build on and further the improvements in competitiveness. In this connection, the markets for factors and goods and services must function in a way conducive to containing costs, margins and prices.

Clearly, in the labour market, we need a stable employment-promoting regulatory framework which, at the same time, affords sufficient flexibility to attune working conditions to the circumstances of the business cycle.

Indeed, greater moderation and flexibility can be seen in wage-setting in recent quarters, as can – and this is also important – a lesser degree of indexation. A more intensive use of the wage and non-wage flexibility mechanisms envisaged in the new regulatory framework would lend continuity to this ongoing improvement in competitiveness.

But our problems of lack of flexibility and competition were not and are not only in the labour market. In the market for goods and services, the recently approved National Reform Plan includes a set of measures aimed at removing obstacles to competition, attaining productivity gains in various sectors and improving the functioning of various institutions.

Private-sector deleveraging and lending

The overindebtedness of households and firms is another of the major problems that arose in the last upturn in the Spanish economy. Private debt/GDP ratios have fallen from their peaks in 2010, but at a relatively slow pace.

The main explanation for this sluggishness lies in the downturn in private-sector nominal income since the onset of the crisis. Unlike in other economies with problems of excess household and corporate debt, such as the United Kingdom and the United States, in Spain weak nominal growth has weighed on the process of debt re-balancing and has made it reside, above all, on a contraction in lending.

The last year in which lending posted a positive rate of change in Spain was in 2008. Since then, net credit flows, both to households and to non-financial corporations, have been negative overall, although there was a very slight increase in lending to households for house purchase in 2010.

In 2012, total lending to the resident non-financial private-sector fell by 5.8%; credit to households fell by 3.7% while that to non-financial corporations decreased by 8%. When total credit to productive activities excluding construction, real estate development and financial services is considered, the decline was not as sharp, standing at 6%. Indeed, credit to productive activities excluding construction, real estate development and financial services was slightly positive in 2010, but has been negative in 2011, 2012 and in 2013 to date.

In considering these developments it should evidently be borne in mind that credit for construction and real estate development activities had to shrink as the cyclical upturn ended and the excesses of the period 2004–2008 had to be corrected.

The problem naturally lies in the negative rates of credit flow for productive activities other than construction and development, and in the contraction of credit for households, both for house purchases and for other purposes. And, in addition to a problem of volume, there is a problem of prices; our households and firms are paying higher interest rates than the average rates paid for comparable transactions in the euro area as a whole, although these spreads are small in the case of financing for house purchase, very high for consumer loans and also substantial for credit obtained by non-financial corporations.

To explain this we must look both at supply-side factors relating to loanable funds by banks, and to demand-side factors on the part of borrowers, households and firms.

Concerning the demand for credit, the recessionary environment, high unemployment, the hitherto scant growth prospects and uncertainty are evidently affecting potential borrowers.

On the supply side, neither liquidity – provided in a stable fashion and at a low cost by the Eurosystem – nor the shortage of capital would appear to be significant explanatory factors.

We believe that on the supply side the two most influential factors are the deleveraging of banks and the lack of projects that may be deemed solvent, or offer sufficient guarantees. There are in fact figures confirming that the most dynamic and productive companies obtain financing; the trajectory of exports is a good indicator in this respect. Yet, at the same time, we know that many small and medium-sized companies (SMEs) – with good results and prospects, and current in their payments to their banks – have difficulty financing even their working capital, or can do so only at a very high cost.

There is a further factor affecting credit flows, both on the supply and the demand sides. Our banking map has changed considerably in recent years, with the disappearance or transformation of many savings banks which, in different regions, traditionally lent to many SMEs. That has led to adjustments in bank balance sheets and to new working relationships between credit institutions and their customers, which may, at least temporarily, be influencing credit flows.

The need for deleveraging has not only been a consideration for credit institutions, but also for non-financial corporations and households; as earlier stated, both households and firms incurred very high and in many cases unsustainable debt levels in 2008–2010. Indeed, a good number of analysts agree that, in order to expand again, our productive sector is more in need of capital than of credit, given that the correction of excessive debt has not been concluded, without ruling out the fact that, evidently, the pick-up in economic growth may assist this correction.

In any event, there can be no economic recovery without a pick-up in credit flows. But the latter cannot ensue from administrative rules that ignore economic rationality or that lead to mistaken decisions from the standpoint of the solvency of banks, including public-sector institutions.

That said, there are measures that should be studied to reactivate credit for the entire economy and, in particular, to SMEs and to the exporting sector. The European Investment

Bank has the means to stimulate loans to SMEs through an increase in its funding to European public-sector banks operating in this area. New arrangements could also be studied for risk-sharing using European funds, for example structural funds, a possibility that is already under discussion. And specific schemes to boost export credit could be studied. Within the Eurosystem, the Banco de España has always been in favour of initiatives geared to supporting more and cheaper credit, through unconventional monetary policy measures that help restore the monetary policy transmission mechanisms.

But we know that the normalisation of credit will not come about, or will be slower and difficult, if we do not complete the clean-up and reinforcement of the solvency of our banking system. This is why it is important to clearly understand what has been done in 2012 to overcome the crisis and to evaluate the current state of affairs.

Clean-up, recapitalisation and restructuring of the banking system and financial reform

I shall focus on the six issues that afford us an overview of the situation: the clean-up efforts in 2012, the strengthening of solvency, the improved liquidity position, developments in non-performing loans, expectations for results in the current year, and, finally, regulatory changes approved in 2012.

Clean-up

Firstly, balance sheet write-downs. Two steps were taken in 2012 which fundamentally determined the balance sheet write-downs that Spanish banks' income statements have had to absorb. The first was the requirement, laid down in the royal decrees of February and May 2012, to set aside provisions to reinforce coverage of loans to the real estate development and construction sector and of foreclosed assets. The second was the balance sheet write-downs stemming from the compulsory transfer to SAREB (the asset management company for assets arising from bank restructuring), at an agreed price, of the assets belonging to the balance sheet segments I have just mentioned. This transfer, made by banks under restructuring or resolution, affected assets totalling €107 billion in terms of their gross book value, with a transfer value of €50.6 billion. With this and other measures, Spanish banks' exposure to the above-mentioned real estate risks has fallen since 2011 by slightly more than half, from €240 billion to €115 billion.

In sum, write-downs by Spanish banks in 2012 totalled €87 billion, compared with €32 billion in 2011.

Solvency

Secondly, solvency. Despite the fact that the major clean-up and provisioning drive by the Spanish banking system in 2012 resulted in total losses of €43.7 billion, the system's level of solvency has improved. That has been possible thanks to the recapitalisation operations performed by directly tapping the markets; to the capital injection financed through the Financial Assistance Programme agreed with the European authorities, for a final amount of €39 billion; to the conversion of hybrid instruments into capital instruments; and to the funds provided by the FROB and the Deposit Guarantee Fund.

Currently, all Spanish banks meet the regulatory capital ratios required. As at the close of the first quarter this year, the solvency ratio of our banking system was 11.6%, compared with the current minimum of 8% required under the Basel Accord.

It is worth stressing – as certain comments made seek to omit this or completely misinterpret it – that the fundamental intention and effect of the capital injections with public funds (whether from the European Stability Mechanism or from the Spanish Treasury) has been to prevent the winding-up of banks, thereby preserving customer deposits.

It would be remiss not to mention here the problem of the hybrid capital and subordinated debt instruments sold to retail customers by credit institutions which, following the detection of capital shortfalls in the stress tests completed last September, were unable to cover their capital needs with their own resources and received State aid. These banks, on requiring public financial assistance, are subject to the terms of the Memorandum of Understanding signed on 20 July 2012, to Law 9/2012 on the Restructuring and Resolution of Credit Institutions and, consequently, to the European Commission's arrangements governing State aid.

The Banco de España, directly through the FROB and the Deposit Guarantee Fund, and via its participation in the Arbitrage Committee set up last March, is collaborating with the other authorities involved and with the banks themselves to find the best possible solution to this serious and multi-faceted problem; not all these instruments are the same, they have not been sold in the same way, and nor will they be given the same treatment under European regulations.

Liquidity

Thirdly, liquidity. Spain underwent a serious external funding crisis in 2012. The origins of this crisis lay both in the crisis in the euro area and negative market perception of our banks' solvency.

A feedback loop between sovereign risk and banking risk emerged, dominated by the so-called "redenomination risk", i.e. the risk that certain countries might abandon the Monetary Union. That led to a very difficult situation for our external funding, which the liquidity supplied by the European Central Bank allowed us to address. In the last quarter of 2012, however, the tensions eased and the liquidity of our banks began to improve. The debit position vis-à-vis the ECB decreased from €410 billion in August 2012 to slightly more than €250 billion last May. Furthermore, the access of our banks to bond markets has improved.

NPL ratio

Fourth, the NPL ratio. In December 2012, after the initial phase of transfer of assets to the SAREB, the NPL ratio stood at 10.8%. By March it had increased to 11.2%. The real estate development and construction sector has the highest NPL ratio (29%), while that of mortgages to individuals is contained (4%), although it is tending to rise. As a result of the major efforts made in terms of write-downs and provisioning in 2012 and the drastic decrease in real estate risk, we can affirm that our banks are able to meet the provisioning needs which may arise this year, in 2013, and also in 2014, if there are any.

Results in 2013

Fifth, the profit and loss account. As we have indicated, in 2012 the large volume of provisioning led to heavy losses. That said, margins performed positively due to the influence of two factors: the fall in interest expenses and the efforts made by many banks to contain their operating costs. Particularly strong efforts have been made by banks which have been restructured in accordance with the plans approved by the FROB, the Banco de España and the European authorities, within the framework of the Memorandum of Understanding of July 2012.

As for this year, the preliminary data for the first quarter allow us to be moderately optimistic, since an overall profit of more than €4 billion was reported. Virtually all the banking groups have obtained profits.

In short, as the EU institutions, the ECB and the IMF have acknowledged, we are overcoming the banking crisis, although risks and uncertainties persist which mean that we certainly cannot consider the crisis resolved. That said, it needs to be reiterated that there is no better way of normalising credit flows than completing this task.

Regulatory changes

Sixth and finally, before discussing the progress made in the Banking Union project, I would like to refer, very briefly, to the most important changes in 2012 in financial regulation which are directly related to the handling of the banking crisis.

The most significant legal change in the financial area was Law 9/2012 of 14 November 2012 on the restructuring and resolution of credit institutions which strengthens the FROB's role and anticipates the future directive which will regulate these processes in Europe. Royal Decree 1559/2012 subsequently regulated asset management companies and, in particular, the regime applicable to the SAREB.

Finally, in the area of bank customer protection, mention should be made of Royal Decree-Law 6/2012 of 9 March 2012 which established various measures to protect those mortgage borrowers in most difficulty, which included the Code of Good Practices, to which virtually all Spanish banking institutions adhered. And, second, Banco de España Circular 5/2012 of 27 June 2012 completed the new legislation in this area, developing the concept of "responsible lending" and enhancing the information system applicable to banking products.

As for banking supervision, the Banco de España, in compliance with the provisions of the Memorandum of Understanding of 20 July 2012, performed an internal review of its supervisory procedures. It created a Committee for this purpose which delivered its findings last October. This Committee made a series of recommendations which the Banco de España is considering and which have already led to changes in the organisational chart of the banking supervision department and in procedures. However, the implementation of the Supervisory Mechanism at the European Central Bank, which we expect to take place in about one year, will clearly involve the need for changes both to supervisory procedures and organisation. Consequently, we need to proceed prudently in this area, our adaptation to the new European model being our first consideration.

Progress toward the banking union

The decisive push towards banking union was given by the European Summit of June 2012, at a time of grave uncertainty and tensions in the euro area. Banking union must be understood, as conceived from the outset, as an essential step to sever the link between banking risk and sovereign risk and to bolster the soundness and irreversibility of Monetary Union.

The banking union will be underpinned by three basic pillars: a single supervisor, harmonised resolution arrangements and a European resolution authority with a common resolution fund. To date, progress has been mixed in each of these three areas.

The European Parliament should shortly approve the legislation that creates the single supervisory mechanism, in which the European Central Bank is to play a central role. The single supervisor will become operational twelve months after this approval, but first the ECB must analyse the solvency of all the institutions it is to supervise, an exercise that will have to be incorporated into the new stress tests to be performed by the European Banking Authority next year.

The Directive establishing the harmonised resolution regime – currently under debate at the European Council and the European Parliament – and the legislation to create a European authority and a common resolution fund are still pending approval. In the latter case, a proposal must be submitted, on a date yet to be specified, by the European Commission.

Conclusions

Ladies and Gentlemen, the theme of my speech has been the difficult adjustment that the Spanish economy is currently going through, which needs to be seen in the context of the largely unprecedented international and European setting.

The advanced economies, the United States, the European Union, the United Kingdom and Japan are operating under extremely loose monetary conditions, with exceptionally abundant liquidity and very low interest rates. Emerging from this situation without any impact on growth and without creating fresh financial turmoil will not be easy and considerable risks will be encountered along that path. Emerging countries continue to record high growth rates, but this momentum is weakening and in 2014 this weakness may become more pronounced.

In the euro area in a scenario of weak economic growth and despite the improvement since summer 2012, monetary and financial markets remain fragmented and the uncertainty about monetary union and governance of the European Union has not been completely dispelled.

In Spain, we have made significant progress in correcting the imbalances affecting our capacity to grow and I think we are on the right path to achieving a recovery of activity and the creation of employment on a sound basis. However, it will be essential not to abandon the policy of reforms aimed at increasing the flexibility of our economy and at boosting competitiveness.

The fundamental task outstanding for the Banco de España is, with the help and close cooperation of the Government and the resolute support of the banking sector, to complete the balance sheet clean-up of our banking system, affording it the utmost solvency, efficiency and transparency. This target, to bring about a system that fulfils its key function to intermediate between savers and investors and which enjoys the full trust of customers and depositors, will, with hard work and rigour, be within our reach.

But we will need something more: to restore economic growth, revive investment, create jobs and overcome the banking and financial crisis, we require legal security. I take this opportunity to request that you work resolutely to safeguard and strengthen it.

Thank you for your attention.