

Luis M Linde: Presentation of the Bank of Spain's Annual Report for 2014

Testimony by Mr Luis M Linde, Governor of the Bank of Spain, before the Parliamentary Committee on Economic Affairs and Competitiveness, Madrid, 24 June 2015.

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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 2014.

Let me begin by reviewing developments in the Spanish economy, the factors underpinning its recovery and the economic policy challenges of strengthening recovery. I shall then address aspects relating to the start-up of the Banking Union and the situation of, and outlook for, the Spanish banking system.

Economic situation and outlook

In mid-2013, the Spanish economy initiated a recovery phase that firmed last year and has continued to do so in 2015 to date. In 2014, GDP grew at a rate of 1.4% while employment did so at 1.2%, the first positive figure since the start of the crisis.

In its Quarterly Report to be published tomorrow, the Banco de España will present a new set of macroeconomic projections.

According to these, the Spanish economy will grow at a rate of 3.1% on average in 2015, an upward revision of 0.3 pp on the projections published in March. On the basis of this change, activity is performing better than projected three months back. Following quarter-on-quarter growth in GDP of 0.9% in the first quarter, the latest information indicates that activity is expected to maintain a strong rate of expansion, whereby a further slight quickening in output is estimated in the second quarter, to 1% in quarterly terms. Average growth in the first half of the year, in annualised terms, is thus expected to be around 4%.

The projections for the rest of 2015 and for next year point to continuing dynamism, with Spain clearly outpacing most of its euro area partners. However, this momentum might be slightly contained by the weakening of some of the expansionary impulses, such as the fall in oil prices and the depreciation of the euro. For 2016, the projections estimate average growth of 2.7%, with greater uncertainty naturally accompanying the longer time ahead involved.

In terms of the composition of spending, the most recent phase of the recovery has been marked by the growing weight of national demand, which has replaced external demand as the main net contributor to growth. Foreseeably, in the near future, this pattern will continue, with a contribution by the external sector to the increase in GDP that is practically neutral in net terms. Exports, particularly to the euro area, are expected to post higher growth, while the tempo of imports will slacken somewhat.

Turning to prices, inflation, which has been in negative territory virtually since the recovery began, has undergone a progressive correction since the start of this year, standing at -0.2% in May further to a rise in the energy component and a gradual pick-up in core inflation. The decline in prices in Spain is proving more marked than in the Monetary Union as a whole, meaning that the inflation differential will continue to help in bringing about an ongoing improvement in our economy's competitiveness.

Inflation might be running at a moderately positive rate at the end of 2015 owing to a combination of several factors. Firstly, the progressive petering out of the effect induced by the heavy fall in oil prices in the closing stretch of 2014 is expected to bring about an automatic rise in the energy component of the CPI in the closing months of this year.

And further, the depreciation of the euro will impact non-energy goods and services prices. In any event, the persistence of considerable slack in the economy, i.e. of substantial unused capacity, means a mild recovery in the inflation rate over the next two years is to be expected.

The factors underpinning growth

The favourable growth outlook is underpinned, above all, by the restoring of macroeconomic equilibria. The progress made and the measures underpinning it have allowed the confidence of both external investors and of Spanish households and firms to be restored.

Improved confidence has also benefited from the changes in certain external conditioning factors, such as those linked to the ECB's monetary policy and to the progress in economic and monetary union, which have prompted an easing in financing conditions. On top of these are other more transitory effects, such as those linked to the low level of oil prices or to the depreciation of the euro.

I shall continue with the analysis contained in the Annual Report, briefly reviewing the key factors behind the recovery.

Budgetary consolidation

Firstly, regarding public finances, the general government deficit met the objective set by the European Council (5.8% of GDP) for the third year running. In 2014, fiscal policy had a less restrictive impact than in the preceding years and was a less prominent conditioning factor of macroeconomic developments.

The reduction in the deficit in 2014 came about as a result of the greater adjustment made at the central and local government levels, since most of the regional governments exceeded the targets set. The budgetary improvement was also the consequence of a similar-sized contribution by revenue and public spending (once the impact of the financial assistance to the banking system is stripped out of spending). The tax take progressively picked up during the year, in step with the cyclical improvement and the change in the composition of GDP. In turn, the budgetary consolidation measures and the cyclical improvement in the economy have brought about a decline in the public spending/GDP ratio, largely owing to the improvement in spending once interest on debt is discounted. Interest payments as a proportion of GDP held at a similar level to 2013, despite the significant decline in the Treasury's financing costs, owing to the increase in public debt.

The public debt/GDP ratio rose in 2014 to 97.7%, thereby meeting forecasts. The latest Updated Stability Programme (which confirms the deficit targets to 2017) presages a continuing increase in debt this year to 98.9% of GDP, with a reduction commencing in 2016, although the better growth now projected for 2015 may improve these projections.

Private-sector deleveraging

Secondly, there has been headway in correcting private-sector indebtedness. Spanish household debt stood at end-2014 at 71% of GDP, 10 pp above the euro area average, when in 2010 we were 20 pp above it; non-financial corporations' debt stood at the end of last year at 92% of GDP, 8 pp above the euro area average, when in 2010 the gap was 35 pp.

In the coming years, the nominal growth of the economy will make for a readier adjustment and will ease the pressure still exerted by past debts on new financing flows. Indeed, new lending was seen to expand in 2014, and this has continued into the opening months of 2015.

Labour market and competitiveness

Thirdly, some of the most visible and significant features of the current phase of recovery are the high rate of job creation and the reduction in unemployment by almost half a million people during 2014.

The pick-up in employment is partly related to firms' greater capacity to adapt their working conditions to the cyclical and competitive situation. This environment has helped usher in a period of wage moderation and an adjustment of relative costs relative to the euro area as a whole, which largely explains the gains in competitiveness recently attained by the Spanish economy.

Turning to prices, the Annual Report pays particular attention to the factors underpinning the recent disinflationary phase in Spain. The analysis concludes that, beyond the influence the prolonged weakness of spending and the fall in oil prices may have had, there has been greater responsiveness by prices to changes in the economic situation, which might be attributed, at least in part, to the reforms in certain markets and services.

Retaining this greater degree of flexibility in price- and wage-setting is vital so that, in the face of adverse shocks, adjustments may be made through relative prices and not at the expense of economic activity and employment, as has traditionally occurred in the Spanish economy in recent recessions.

There has likewise been a notably sharp correction of the external imbalance, with external surpluses being attained in the past three years, albeit of a smaller amount in 2014. Nonetheless, the correction of the International Investment Position (IIP), a debtor position equivalent to 93.5% of GDP at the close of 2014, is proving very gradual, which denotes the need to maintain the gains in competitiveness achieved, so as to improve the current account balance and reduce our still-high level of external debt.

The role of external conditioning factors

Let me now refer to the external conditioning factors in the recovery of the Spanish economy.

The world economy lost momentum in 2014, particularly so in the euro area. Euro area growth was very weak in the second and third quarters of the year and only thereafter did it begin to show somewhat greater strength. On this occasion, moreover, Germany and France – the area's two biggest economies and two of our biggest trading partners – were also affected. The latest ECB projections point to a moderate recovery, whereby the area's GDP is expected to grow 1.5% this year and 1.9% in 2016. These are, then, clearly lower rates than those projected for our economy.

Other external developments have provided a boost to activity. I have already mentioned the fall in oil prices. Unquestionably, though, the most durable positive external impulses stemmed from the ECB's monetary policy and the start-up of the Banking Union.

Throughout last year and in 2015 to date, the ECB has continued to deepen its expansionary monetary policy stance. Once again, it has combined conventional measures, cutting official interest rates and placing the deposit facility in negative territory, with other, unconventional measures, such as a new private-sector credit-linked lending programme and the launch of an ambitious plan to purchase private- and public-sector securities, which is expected to run until September 2016 and, in any event, until inflation resumes a path more in keeping with its medium-term objective, namely around 2% for the ECB.

These expansionary monetary impulses, along with the expectations of a change in the US monetary policy stance and of an interest rate increase by the Federal Reserve, have depreciated the euro and reduced the Spanish economy's financing costs. The market fragmentation caused by the crisis may be considered to have been reversed. Such fragmentation was hampering the full transmission of the expansionary monetary measures to our economy. The start-up of the Single Supervisory Mechanism (SSM), the first step of the Banking Union, has played an important role in this process of financial normalisation.

The start-up of the Single Supervisory Mechanism

In November last year the SSM commenced operating and, since then, with the participation and support of the national authorities, the ECB has taken control of banking supervision throughout the Monetary Union.

As a prior step, an ambitious comprehensive assessment of European banks was undertaken in 2014, whose positive results contributed to increasing investor confidence in the European banking system. As is known, our banks comfortably passed the test, confirming the favourable results of the restructuring and recapitalisation programme carried out in 2012 and 2013 with the agreement and assistance of our EU partners.

The comprehensive assessment of significant euro area banks was twin-pronged, entailing an asset quality review and stress tests to determine banks' resilience in hypothetical adverse scenarios.

The results obtained by Spanish banks were favourable. First, I should highlight the fact that Spanish banks are those with fewest adjustments to make as a result of the asset quality review which, unlike the stress tests, is not based on hypotheses but on a detailed balance sheet review. As regards solvency, only one bank stood slightly below the thresholds set in one part of the exercise and, in any event, that same bank had already adopted capital-strengthening measures in 2014 on a scale far exceeding that needed to cover the shortfall identified.

In the course of 2014, both the ECB and the national authorities made a significant effort to address the challenge posed by adaptation to the new supervisory framework. In this respect, to make our joint work easier, the Banco de España has reorganised its Directorate General of Banking Supervision, creating a structure that mirrors that of the ECB's SSM.

In 2015, its first year of operation, the SSM has defined a list of priorities, bearing in mind the environment and the main risks to the banking sector. These include most notably profitability.

European credit institutions have operated in recent years under adverse macroeconomic conditions. In a market characterised by low interest rates, bank margins have been subject to downward pressure which, combined with asset impairment losses, has affected their capacity to obtain profits. One of the priorities of European supervision for 2015 is to identify the determinants of profitability and to attempt to detect aggressive strategies contrary to financial stability.

In the prudential realm, one of the main challenges is for banks to adapt to the stricter capital requirements of the new Basel III solvency regime. The SSM, like the Banco de España in

previous years, issued a recommendation of prudence to banks in connection with the distribution of its dividends. In our case, having regard to the difficult economic and banking situation in 2013, dividend payments above 25% of profits were broadly restricted; the European supervisor's recommendation imposes restrictions solely on banks facing a tighter situation in terms of solvency.

One priority matter is the review of the national discretionality and options permitted under European solvency regulations, in order to harmonise the legislation applicable to SSM-supervised banks. The review has begun recently and is being jointly tackled by the ECB and the national competent authorities.

The second element of the Banking Union, prepared in 2014 with a view to its entry into force in 2015, is the Single Resolution Mechanism (SRM), which establishes a common European framework for the restructuring and resolution of credit institutions.

The aim is, should the case arise, to provide for the management of situations of bank non-viability while preserving the stability of the financial system, minimising public financial support, safeguarding depositors and ensuring the continuity of the critical economic functions of the banks in question. All of the foregoing might influence the management of bank balance sheets and have a particular bearing on the composition of their liabilities, part of which must be eligible for absorbing losses and for their recapitalisation.

The SRM comprises two elements: the Single Resolution Board and the Single Resolution Fund. The latter, by means of contributions from the banking sector, is expected to amount to €55 billion in 2024.

In the national arena, the recently approved legislation on the recovery and resolution of credit institutions and investment services firms distinguishes between pre-emptive resolution functions, which correspond to the Banco de España in the case of credit institutions and to the National Securities Market Commission (CNMV) in that of investment services firms, and enforcement resolution functions, attributable to the Fund for the Orderly Restructuring of the Banking Sector (FROB), which sits moreover on the SRM Board, with the Banco de España having observer status.

Performance of credit institutions in 2014

Before concluding, I shall review the recent performance of Spanish credit institutions.

The year 2014 saw an improvement in financial conditions and a recovery in activity and employment. Lending to the resident private sector in Spain continued to shrink in 2014, in line with the need for the deleveraging of the Spanish economy; that said, the rate of decline of lending eased (from 8.3% in 2013 to 6.4% in 2014). At firms not engaging in construction and real estate activities, credit fell much less, shifting from a negative rate of 9% in 2013 to a still-negative rate of 1.5% in 2014. The figures available for 2015 suggest that the year will conclude with credit running at a rate of change very close to zero or in positive territory for the first time since 2009.

One key aspect in 2014 was the fact that non-performing loans (NPLs) to the resident private sector fell both in absolute terms (by more than €24 billion) and in terms of the NPL ratio, which declined by almost 1 pp to 12.9%.

In 2015 to date, this trend is holding, as NPLs have fallen to 12.3%. Resident private-sector refinanced exposures have fallen by 4.5% and account for 14% of the total, a proportion still highly influenced by forborne exposures to real estate development and construction companies.

It is also worth pointing out that households and non-financial corporations are changing the composition of their savings in response to the very low interest rate environment, meaning that bank deposits have declined while units in investment funds have increased significantly.

Spanish banks' attributed profits in 2014 increased by close to 34%, continuing the recovery initiated in 2013. Despite the backdrop of declining credit and low interest rates, net interest income rose by almost 5% owing to financing costs falling at a swifter pace than the return on financial products. Also, the containment of operating expenses and the decline in asset impairment losses have contributed to the improvement in results.

However, the persistence of the environment of very low interest rates and the presence of a significant volume of non-productive assets will continue to bear down on the income statement. That will lead banks to reflect on a sustainable business model, involving the application of new technologies, new activities and an office and staffing structure better tailored to attaining this model.

In December 2014, the top-quality common equity tier 1 (CET1) capital ratio of our banks stood at 11.8%. This ratio rises to 13.6% for total capital. Both figures amply exceed the regulatory minimum levels. Even if the standards scheduled to be in force from 2018 – when Basel III becomes fully applicable – were to be applied, these percentages would remain above the minimum levels (9.9% and 12.1%, respectively). Moreover, the recourse by banks to Eurosystem funds continues to fall.

Notwithstanding this positive assessment, Spanish banks must continue strengthening their capital and their loss-absorption capacity in order to withstand the new macroeconomic environment, heightened competition and the new, more demanding and complex regulatory framework.

Conclusions

Overall, the outlook for the Spanish economy has improved in the recent period. Its degree of vulnerability to potential shocks has progressively diminished as headway has been made in correcting its imbalances, strengthening economic activity and generating employment.

Nonetheless, the effects of the crisis have been very serious and condition our economy's growth capacity in the short and medium term. Accordingly, economic policy measures should be geared to shoring up the foundations of the recovery and to seeing through the correction of imbalances.

The cyclical situation in the euro area and in Spain means the maintenance of a demand-side policy mix supportive of the recovery is foreseeable. In the case of monetary policy, this is because of the commitments assumed by the ECB, which I referred to earlier. And in the case of budgetary policy, because adhering to the fiscal consolidation path will be compatible with a progressively less contractionary or more neutral contribution by the public sector to growth.

In the current economic circumstances, it will continue to be necessary to complement these measures with reforms aimed at enhancing competitiveness and lowering the obstacles to a more rapid absorption of unemployment. Such actions take on particular significance in a situation like the present in which the aggregate level of debt in the economy is still high and further gains in competitiveness come up against a less propitious environment, given the low inflation in the euro area and the envisaged low growth in productivity.

Reducing unemployment, which is at a very high rate despite the favourable developments in Social Security registrations and the reduction in registered unemployment, remains our major economic policy task. In this connection, wage bargaining must allow for the different situation of different firms and sectors to be taken into account, avoiding as far as possible the return to now-superseded wage indexation practices.

Considerable progress has been made in correcting the fiscal imbalance, without forgetting the constraints that such a high level of public debt imposes. In the short and medium run,

perseverance with fiscal consolidation on the basis of a growth-conducive revenue and spending mix that ensures compliance with the Budgetary Stability Law will be unavoidable.

I should like to conclude with some thoughts on the challenges posed by long-term growth for the Spanish economy.

In Spain, as in most of the countries affected, the crisis has had a large-scale impact on the level of output, as a result of sizeable capital and job destruction. The future growth of the Spanish economy will be influenced by how we manage to overcome these effects, but also by the capacity to raise productivity, whose low pace of growth has continuously affected us.

Against this background, it is vital to continue with and deepen reforms that boost investment, lower the obstacles to competition and remove the barriers preventing a suitable reallocation of productive resources towards the firms and sectors with the highest growth potential.

The Annual Report concludes that these barriers are the outcome of various factors: inappropriate regulations, small firm-size, limited regional and sectoral job mobility, a degree of educational mismatch between labour supply and demand, and insufficient innovative capacity. Overcoming these constraints calls for responses that are not always straightforward or simple either in technical or political terms. But it should be stressed that these reforms can bring about positive synergies with the expansionary monetary policy being pursued by the ECB, even in the short term, owing to their impact on growth expectations.

Thank you.