

Miguel Fernández Ordóñez: Situation of the Spanish economy and financial sector

Speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the XV Financial Sector Meeting "The way forward for the Spanish banking business model", Madrid, 15 April 2008.

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I shall be focusing today on the Spanish economy which, naturally enough, has been affected by the changes in the international environment prompted by the further slowdown in the US economy, the rising course of oil prices and the prolongation of the bout of financial turbulence.

To this end, I shall begin with a brief reference to the situation in the United States and in Europe, focusing thereafter on the macroeconomic outlook for Spain in an attempt to define its degree of exposure to the international financial turbulence. Finally, I shall offer some economic policy considerations.

It is in the United States that the deterioration in macroeconomic conditions has been most marked. The effects of the sharp adjustment in the US real estate sector have been amplified by the consequences of the instability in international financial markets, severely affecting business and household confidence. The outlook of most analysts for 2008 points to a strong deceleration in the first two quarters of the year, and even to a recession at some point along the line, although any more medium-term projection is shrouded in considerable uncertainty.

In the euro area, some of the risks to continued economic dynamism progressively materialised during 2007. These were, namely: the appreciation of the euro; higher oil, commodity and food prices; worsening confidence and tighter financing conditions, prompted by the financial strains; and, of course, the effects of the above-mentioned weakening in the US economy. In Europe, this made for a slowdown in the pace of activity in the second half of the year, although euro area growth remained more robust than in the United States. The resilience shown by the euro area has led analysts to project growth for the coming quarters that will be slacker but not far off potential, albeit with a similar measure of uncertainty to that expressed in the case of the US economy.

Turning to prices in the euro area, the rate of inflation stood at 3.5% in March 2008. This worrying figure reflects the strong short-term upward pressures stemming from energy and food price rises in recent months. Foreseeably, although inflation may hold at a rate of over 2% for a number of months more, it should begin to move back to this level in the second half of 2008. That said, considerable upside risks remain, linked essentially to the possibility of second-round effects emerging in wage- and price-setting.

The Spanish economy ended the year 2007 with a GDP growth rate (of around 3.5%) that we might qualify as robust. But it began to show signs of undergoing a change in cycle, following an upturn that had lasted for more than ten years. Into 2008, the information available confirms this perception of the domestic macroeconomic situation.

In 2007, GDP growth averaged 3.8%, the result of some easing in domestic demand and an improvement in the contribution of net external demand to output growth. Against this background, the slowing trajectory on which the Spanish economy embarked during 2007 was consistent with the tailing off of some of the impulses behind the buoyancy of spending in previous years, and with the maturing of the business cycle. Undoubtedly, the raising of interest rates by the ECB – from end-2005 to June 2007 – and the increasingly subdued rises in house prices began to temper consumption and residential investment decisions as early as 2006. This gradual loss of momentum in domestic demand continued in 2007, but

was not reflected on a similar scale by GDP, owing to the offsetting effect of net external demand.

Adding to this domestic adjustment dynamic was, from summer 2007, the effect of international financial market instability. This translated into a deterioration in agents' expectations, and made itself felt in some spending components – consumption and, above all, residential investment – as early as late 2007, but more clearly in the opening months of this year.

However, the weakening in consumption is based on comparison with the relatively high end-2007 figures, with growth close to 3%, held up by the dynamism of disposable income. And I believe it is particularly worth noting that investment in equipment ended the year at a rate of increase of close to 9%, highlighting the robustness of business activity in the closing months of 2007 against a backdrop of sound corporate earnings and a favourable demand outlook.

The demand for housing, which had moved onto a mildly slowing path in mid-2006 in response to higher borrowing costs and lower real estate appreciation expectations, appears to be showing greater sensitivity to the deterioration in agents' confidence, according to the latest available information. Recent figures reveal a loss of momentum in activity and employment in the construction and related sectors, as they do more generally, but on a lesser scale, in the rest of the economy. In any event, when considering the ongoing adjustment in the residential sector, which was largely inevitable following a prolonged phase of growth in supply, we should not overlook the considerable forces underpinning the demand for housing in the medium term in Spain, which should help temper the scale and intensity of the adjustment.

The performance of trade in goods and services with the rest of the world has been relatively favourable in recent quarters, and has helped net external demand to make a positive contribution to GDP growth and, therefore, to alleviate the loss of momentum in domestic demand. I would highlight the resilience of exports in the past year, despite the significant appreciation of the euro and the somewhat diminished dynamism of export markets. Indeed, an incipient change in the direction of our exports towards more buoyant markets is becoming perceptible.

Nevertheless, the nation's net borrowing continued to increase, albeit at a slacker pace than in previous years, reaching 9.5% of GDP in 2007, mainly due to the marked and expected deterioration in the income balance. The tendency towards a gradual easing in investment by firms and, above all, by households should help move the current account deficit onto a declining course.

The pace of employment generation adapted to the gradual slowing of activity in the second half of 2007, ending the year at a growth rate of 2.5%. This trajectory has continued, somewhat more sharply, in the opening months of 2008. It has particularly affected employment in the construction industry and also, though to a lesser extent, in manufacturing activities, some of which are closely related to the construction branch. In contrast, employment in services is proving far more resilient.

Despite this loss of dynamism in the labour market, labour costs began to rise in 2007, when compensation per employee grew at a rate of 3.6%, and have continued to do so in early 2008, with growth in wage settlements to February of 3.5%. It is highly likely, once the effect of indexation clauses (for the deviation by inflation from its official target in 2007) is taken into account, that labour costs will rise by more than 4% in 2008 for almost 70% of private-sector workers subject to a collective bargaining agreement.

This development is rather unfortunate given the change in cycle facing the Spanish economy, as it may ultimately have an adverse effect on firms' hiring decisions, accentuating the employment adjustment in a setting of macroeconomic uncertainty. But it is also inappropriate from the standpoint of its impact on inflation, at a time when this variable, as

you know, is deteriorating sharply. In recent months, the growth rate of the consumer price index has exceeded 4.5%.

Undeniably, the rising course of inflation, driven by the substantial increases in oil and agricultural commodity prices on international markets, is a phenomenon common to most economies. But in Spain these pressures are compounding a situation in which upward biases in cost and price formation persist, accentuating the risk of the deterioration in inflation spreading to the rest of the economy.

With a view to the immediate future, the macroeconomic projections recently published by the Banco de España suggest national demand will continue to lose steam, in both its consumption and capital investment components. This is expected, however, to be partly offset by the improved contribution of the net external balance. In this setting, GDP growth is projected to stand at around 2.4% in 2008. As to the inflation outlook, the private consumption deflator will foreseeably increase to an average rate of 3.6%, albeit on a slowing path during the year.

On numerous occasions the Banco de España has indicated that the Spanish economy has undergone far-reaching changes in recent years. These have increased its growth potential and provided it with elements of flexibility that leave it better placed to face any shocks that may arise. Acting along these lines have been Spanish euro area membership, notable population dynamism and the investment drive made in recent years, which have equipped the Spanish economy with sound foundations to maintain sustained growth in the medium term. Undoubtedly, though, the external turbulence that arose during 2007 may detract from the effectiveness of this flexibility.

One possible source of risks is lower growth of the world economy, either because certain economies – particularly the United States – may contract more than expected, or because the loss of dynamism may spread more intensely to other areas. This would hinder the buffer role that external demand should play in the context of slowing domestic demand. Another series of potential risks are those that would arise from any prolongation of the financing difficulties in international markets generated by the turmoil. Let me go more deeply into this second area, as I believe it is of particular relevance for this Meeting.

Much has been written and said in recent months on the origins and propagation of the turbulence. I shall therefore focus here on the consequences of this episode for the Spanish financial system, a matter on which there has also been no shortage of comment, though not perhaps always well-founded.

As you know, Spanish credit institutions have based a substantial portion of their business in the recent upturn on the granting of loans for housing development and purchases. And a large number of these loans have ultimately been repackaged as negotiable financial instruments by means of securitisation.

These two phenomena are, as you all know, at the root of the problems experienced by certain credit institutions in other regions. But before drawing any insufficiently founded conclusions from this, we must bear in mind the differences between Spanish institutions and those beyond our borders that have been more severely impacted by the effects of the turbulence. As I shall explain, these differences are substantial and place Spanish financial institutions in a sound position to withstand these effects.

The first and certainly one of the most significant differences lies in the fact that Spanish banks have kept the risks of the loans they have securitised on their balance sheets. The "originate-to-distribute" model followed elsewhere has not been developed at all in Spain and, consequently, credit institutions' incentives to value loan risks in a cautious and rigorous manner have not been weakened. Under these conditions, it is perfectly understandable why products like the US subprime mortgages, which triggered the current situation, have not emerged.

Secondly, Spanish banks have used securitisation not as a mechanism for transferring risks off their balance sheets, but as a means of raising resources on the wholesale financing markets in order to meet the demand for loans from households and businesses. That gives rise directly to a second significant difference in favour of the Spanish financial system, since when the main objective is to raise funds and not transfer risks, it is not necessary to resort to the issuance of overly complex financial instruments.

Indeed, the securities issued by Spanish banks are characterised by their simplicity, by their relatively long maturities (matching, therefore, those of the assets they are financing) and by their needing only moderate credit enhancements to attain a high rating. This is clearly in contrast with other systems, in which complex structured products and rather ad hoc vehicles such as conduits and SIVs have proliferated to channel the financing of low-grade loans.

Likewise, in Spanish bank portfolios the weight of these structured products, which have burgeoned in the countries most affected, and of the securities issued by these special financing vehicles, is negligible. In Spain, the traditional retail banking model has continued to prevail. And this prevalence also explains the minimal direct exposure of our financial institutions to other factors of risk associated with recent developments in the international financial markets. Such is the case, for instance, with leveraged buy-outs (LBOs) and the so-called monolines, which specialise, as you know, in insuring the payment of numerous bonds, including those linked to the securitisation of US subprime mortgages.

In these circumstances it is easy to understand why the profits reported by Spanish banks in 2007 have scarcely been affected by the financial turbulence and have continued to increase at a rate of around 19%, firmly underpinned by their improved efficiency ratios. Their profitability, both in terms of assets and in relation to capital, also grew compared with 2006. Indeed, the ROE stood at almost 20%.

Profitability is obviously the first line of defence for Spanish banks against any adverse shock. But their resilience is also based on two other pillars: a significant volume of provisions, accumulated by the system during the period of strong credit growth thanks to the prudential mechanisms set in place by the Banco de España in the past; and a comfortable solvency position. To quantify these two aspects, loan loss provisions widely exceed doubtful assets, while the system's solvency ratio, measured in accordance with the Basel regulatory standards, is 11.4%, 3.4 percentage points higher than required.

These factors mean that Spanish credit institutions face the current situation from a position of soundness which, in the international context, is fairly unique. Soundness however is not a synonym for immunity and it would be imprudent, and not befitting a supervisor, to fail to consider thoroughly the potential risks.

In this respect, I should first like to refer to the recent developments in the doubtful assets ratio for loans granted to households for house purchase. For the last few months, this ratio has been on a rising trend. And as it will no doubt continue to grow in the future, I feel we should view it as a worrying factor, but only a moderately worrying one, for the following reasons. Primarily, because we must not forget that this ratio had been at exceptionally low levels as a result of the high rates of growth of lending itself (the denominator of the ratio), so that increases would have been expected even in the absence of the present tensions. Secondly, because the current levels are still relatively low and well below those of other markets. However, in addition, there are some specific features of our financial practices that tend to limit the scope of this source of risk. I am basically referring to the fact that in Spain, unlike in the United States, households tend to default on their mortgage payments only in really extreme conditions.

The causes for concern may be greater in the case of loans for property development. True, the coincidence of the maturing of the property cycle and the triggering of international financial tensions has been particularly untimely for the Spanish economy. But, the stress tests we have performed at the Banco de España to calibrate the potential scale of this risk for banks show, broadly speaking, that the policy followed in recent years of accumulating

provisions and capital has given rise to a buffer that would enable shocks of an order of magnitude comparable to those experienced at the height of the crisis in the 90s to be absorbed.

I now come to what I consider to be the main source of uncertainty at the present moment. This is none other than future developments on the international wholesale financing markets, where the possibilities of raising funds have been at extraordinarily restricted levels that are not in keeping with a developed international financial system.

Spanish banks have so far largely managed to evade the consequences of this sudden financial market squeeze. Firstly, because their liabilities were issued at relatively long maturities, so that the need to refinance the loans granted is arising much more smoothly than in other systems in which the relative weight of short-term securities is greater.

The low level of dependence on funds raised in the interbank deposit markets has been another mitigating factor. I should point out here that once the subsidiaries and branches of foreign banks have been excluded, whose liquidity management is strongly governed by the geographical diversification strategies decided by their parents, the rest of the Spanish credit system does not borrow in these markets but instead maintains a net credit position in them.

And I should not fail to mention either that the recent dynamism of Spanish households' deposits and the progressive return of credit to a more sustainable growth rate has also helped cushion Spanish banks' funding requirements.

In these conditions, the Spanish credit system has found alternatives to recourse to the markets for medium-term financing to cover its funding requirements. More specifically, issuance of shorter-dated securities, such as commercial paper, has been stepped up and more intensive use has been made of the leeway provided by the Eurosystem's monetary policy operational framework to cover liquidity requirements. In relation to the latter, I should like to emphasise that this possibility has been available to Spanish banks, as it has to all other banks of the area, since the very outset of monetary union, and it therefore comes as no surprise that it is used to a greater extent at times like the present. That said, the use currently being made of this facility remains moderate, as shown by the fact that the liquidity raised by Spanish banks as a proportion of total Eurosystem operations is barely commensurate with the weight of Spanish GDP in the euro area, or that this facility accounts, according to end-2007 data, for only 1.3% of the total bank balance sheet.

Clearly, recourse to these alternative facilities is to some extent temporary; it is taking place in a situation of heightened uncertainty and it is not reasonable to think that it is going to be perpetuated. But it is also clear that if this episode continues much longer, its effects on the Spanish economy may be significant, as is to be expected in the case of an economy in which external financing is one of the fundamental elements underpinning growth.

When the ability of the international financial system to perform its role of allocating resources efficiently is seriously curtailed, as at present, the financial soundness of borrowers is not sufficient to attract the financing they need. Thus, if the strains currently affecting the main wholesale markets for medium and long-term financing are prolonged excessively, we cannot ultimately rule out greater constraints on the raising of external financing by the economy.

The poor functioning of these wholesale markets has a global dimension and there is relatively little that the Spanish authorities can do to help mitigate it. However, the Banco de España can and will proceed to ensure that Spanish banks continue managing their risks prudently and have appropriate risk provisioning policies that guarantee their financial soundness. This is undoubtedly the best way of ensuring that, once uncertainties have been dispelled and normal market functioning restored, financial institutions can continue to efficiently perform their role of channelling financial flows between our country and the rest of the world. In addition, the Banco de España will continue encouraging banks and savings banks to start issuing medium-term bonds again and to place them on the international

markets. The positive experience of Spanish banks that have already done this during the last fortnight, and the improvement in bank risk recorded in certain markets, make these issues a unique window of opportunity for the financial system's use of international euro markets to return to normal. Also, and as part of the Eurosystem, the Banco de España will continue to help facilitate the adequate provision of liquidity, to ensure the proper functioning of money markets.

But, apart from the functions assigned to the Banco de España in relation to financial stability, in our capacity as a central bank and bank supervisor, it is also our duty to contribute our opinion, in the performance of our task of overseeing macroeconomic stability, on the design of the response that should be framed in a situation such as that described. This response must include both the role of the economic policies of the various tiers of government and the responsibilities that must be assumed by the various economic and social agents.

We should all accept that in a situation like the present one in which the economy is facing a slowdown, in an adverse international setting and surrounded by risk factors, it is more important than ever that economic policies be firmly geared in two directions: first, towards safeguarding macroeconomic stability; and further, to promoting the adoption of structural measures and reforms in product and factor markets, to enhance the degree of competition in the environment in which agents take their decisions, the mobility of factors of production and the flexibility of price and wage-setting mechanisms. I believe that both strategies generate substantial synergies if they are pursued simultaneously. And in Spain we have the experience of the key role they have played in the real convergence of the Spanish economy over the last decade.

And this is so because it is essential that the response of supply and demand to the changes required to rebalance the various sources of spending and the various sectors of activity should be flexible, so as to ensure that the slowdown is mild and leads promptly to a new path of high growth, in line with the economy's potential, that is more balanced and sustainable.

This is the stance that should, in my opinion, inform the actions of central government and other government bodies, which in Spain's highly decentralised system of regional government have very significant responsibilities, as well as the behaviour of economic and social agents, whose attitude may determine the degree of flexibility of the productive system and of the institutional framework and the viability of the necessary reforms.

We should be aware that there is very little room for expansionary demand policies here and that inappropriate use of such policies may even be counter-productive. Monetary policy ceased to be an autonomous economic policy tool a decade ago. Its primary objective is to maintain price stability in the euro area over the medium term. From the point of view of domestic requirements, the monetary and financial conditions in which Spanish households and businesses have been operating have been becoming progressively tighter and are currently more in line with the need to stem inflationary pressures in the Spanish economy.

For its part, the fiscal position is in a favourable starting position since public finances were again in surplus in 2007 (2.2% of GDP) and the debt ratio stood at 36.2% of GDP, levels unprecedented in the recent history of the Spanish economy. These results reflect the strong commitment of previous governments to fiscal discipline, but also substantial growth of the Spanish economy in recent years and the buoyancy of the property market. That has resulted in strong growth in tax revenues, exceeding that seen in previous upturns. Accordingly, the fiscal projections that are consistent with the macroeconomic scenario I have set out today point to the fiscal surplus almost disappearing in 2009.

With this in mind, when designing the appropriate fiscal policy strategy for the downturn in the Spanish economy, it makes complete sense to give free rein to the automatic stabilisers, whose movement tends to counter cyclical fluctuations. This is one of the great advantages arising from the fiscal consolidation drive that took place during the expansion. The

automatic nature of these instruments makes them the most suitable ones for stabilisation, because they respond rapidly to changes in the cycle, they help agents to form correct expectations regarding the authorities' actions and they boost confidence. However, discretionary increases in public spending and tax reductions beyond the specific scope of the automatic stabilisers should be avoided, since they may compromise the maintenance of medium and long-term budgetary stability and eliminate the fiscal policy leeway to respond to sharper slowdowns.

Maintaining a stance of budgetary stability during the downturn is, in any case, compatible with measures that may alter the composition of revenues and spending, without giving rise to a permanent deterioration in the budgetary situation, especially if such measures contribute to enhancing the quality of public finances and the efficiency of the economy. But, for this to be possible, it is essential to strive to contain expenditure, by means of countermeasures in those areas that offer the most scope for cost reductions, at all levels of general government.

It would seem, then, that the promotion of structural measures and reforms, geared towards improving the functioning of markets, making wage and price-setting mechanisms more flexible and facilitating the reallocation of factors of production across sectors, is the main instrument available to economic policy makers and economic and social agents to enable each, in their respective areas of responsibility, to contribute to easing the downturn and promoting prompt recovery.

All matters relating to the functioning of the labour market, good industrial relations, collective bargaining and outstanding reforms take on great importance in the current situation. This is because the dynamism of the Spanish population as a supportive factor for limiting the intensity and scope of the slowdown largely depends on labour market flexibility. This is especially so at the current juncture, with rising wages and a deteriorating inflationary situation. Hence, the search for formulas permitting a resumption of a trajectory of wage moderation has become a priority, such moderation, with the support of social agents, having yielded such good results in terms of employment generation in the recent past. Among other measures, I have in mind changes to the current wage indexation arrangements, which tend to prolong the impact of inflation surges. Changes are also needed in the collective bargaining framework and in labour hiring, in order to facilitate the adjustment of wages to the new cyclical situation and to smooth the adjustment in employment.

Obviously, however, these measures need to be complemented by resolute reforms to the competitive environment in which firms and agents take their decisions through liberalisation and deregulation policies that help reduce the constant growth in profit margins in less competitive sectors and to boost efficiency and productivity. From the viewpoint of the long-term needs of the Spanish economy, all this should be accompanied by improvements in education and in training in order to adapt workers' skills to the new requirements and to boost their inter-sectoral mobility.

Allow me one final reflection not so much on what should be done as on what should not. It is true that the global slowdown is leading many governments to embark on different forms of protectionism, responding to the calls of those economic agents who are demanding help against foreign competitors. It is a mistake to succumb to such calls. Spain should not follow this bad example, since any measures in favour of specific agents solely on the basis of their nationality would ultimately harm other Spanish companies and all Spanish citizens. On the contrary, we should continue to adhere to increasing openness to competition and to the foreign investment that has contributed so much to our well-being in recent decades, focusing our efforts on promoting a climate conducive to business activity and on removing all obstacles and rigidities that hamper enterprise.

To conclude, I wish to affirm my confidence that the Spanish economy has sufficient factors of resilience to successfully face the inevitable slowdown, even in an unfavourable external environment. Such resilience has been built up through the efforts of everyone (State, central

government and other government bodies, and social agents), and has demonstrated the benefits of policies geared towards stability and long-term growth, particularly when the economy faces significant challenges such as those at present.

Thank you very much.