

Luis M Linde: The recovery of the Spanish economy

Speech by Mr Luis M Linde, Governor of the Bank of Spain, at the XVI Congreso Nacional de la Empresa Familiar, Instituto de la Empresa Familiar, Madrid, 28 October 2013.

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Let me begin by thanking you for inviting me to take part in this Congress. It is an important meeting and offers me the opportunity to discuss, firstly, the recently released data suggesting an improvement in economic activity across the European Union, and also in Spain. And, secondly, to address the strengthening of the Spanish banking sector and its role in the start of the recovery we expect in 2014.

In the euro area, the indicators signal that activity is beginning to pick up, and most analysts foresee that this recovery can take root.

As a member of the European Central Bank's Governing Council I should, before continuing with my address, highlight the contribution of the monetary policy applied by the ECB to containing the crisis.

In facing up to the crisis, the European Central Bank has used its full range of measures, providing abundant liquidity at increasingly lower prices. The easing of monetary conditions has led to a substantial reduction in official interest rates, to their current level of 0.5%, almost 4 pp down on that five years ago.

The monetary easing has been bolstered, moreover, by a policy of abundant liquidity supply in ordinary operations; extraordinary operations at terms of up to three years; the broadening of the range of guarantees or collateral accepted for liquidity-provision operations; the launch of asset purchase programmes; and, finally, the approval in August 2012 of the Outright Monetary Transactions programme, which has not had to be used, but which is one of the "weapons" at our disposal and which played an important role during the very difficult times the euro area experienced in the summer of 2012. And lastly, in this area, the latest novelty: the "forward guidance" policy, involving the more precise communication of the future behaviour of official interest rates, shadowing the measure used some time ago now by the Federal Reserve.

Outside the monetary policy sphere, mechanisms have been set in place in the European Union to provide funds to those Member States deprived of access to the capital markets. Also, a reform of the economic governance of the area – whose ultimate scope may prove substantial – has been launched.

Turning to what we call the "real" economy, following six consecutive quarters of contraction euro area GDP posted a year-on-year rate of increase in the second quarter of this year of 0.3%. And analysts expect a positive though moderate rate for the third quarter. The latest projections by international agencies place GDP growth for the euro area countries as a whole at around 1% in 2014 and 1.5% in 2015, with this naturally against a background of price stability.

With specific regard to the Spanish economy, two positive indicators have just been released. First, on the flash estimate available, GDP is expected to have grown by 0.1% in the third quarter compared with the second quarter. This is the first positive figure after nine consecutive quarters of contraction. The primary explanation for this figure lies in the contribution of the external sector, underpinned more by the export performance than by the containment of imports.

As to the composition of domestic demand, some changes are appreciable: private consumption spending is estimated to have grown slightly, albeit still against a backdrop of great weakness, the result of the decline in disposable income, the loss of household wealth and high household debt.

The second positive indicator stems from the latest Labour Force Survey, with a reduction in the number of unemployed, an increase in numbers employed and a significant fall in the rate of increase of unemployment, at 2%, compared with 16% a year ago and almost 5% in the second quarter.

These signs of a possible change for the better in our economy must be placed against the background of the **correction of the serious imbalances** built up during the previous expansion.

As to the most discussed and absolutely essential correction, that of the budget deficit, I will simply say that progress has been made under very difficult conditions, amid a recession: this year, 2013, we will run a surplus on the structural primary balance which will be maintained and widened, we believe, in 2014. But as well as budget deficit achievements, we should highlight the correction of the external deficit, the adjustment of competitiveness, the reallocation of resources from construction to other industries, and headway in deleveraging.

The buoyancy of exports, along with the sluggishness of purchases from the rest of the world, in line with the fall-off in national demand, has allowed the contribution of the external sector to activity to reach an unprecedented scale. In 2013, Spanish export penetration in foreign markets increased notably in all geographical areas, markedly so in the emerging and developing economies. At the end of 2013 the Spanish economy will have a net external financing position of over 2% of GDP, above the related 1986 figure, which was the peak recorded to date in our external sector statistics.

As to our main customers and suppliers, namely the euro area members, the recovery in **competitiveness** has been achieved through the direct containment of costs and margins, and not, evidently, through the nominal depreciation mechanism. This route is more difficult and slower, but the gains in competitiveness thus obtained are more structural, i.e. more durable.

Wage moderation has played a very important role here. The sensitivity of wages to the cyclical situation has stepped up since mid-2012 which, in principle, suggests the labour market is functioning more in step with developments in the economy and the clearly declining trend of inflation. Indeed, in September the consumer price index posted a year-on-year rate of 0.3%, resuming a favourable difference vis-à-vis our European partners.

The excessive **dependence of the Spanish economy on the construction sector** in the previous expansion no doubt entailed a factor of vulnerability. From the onset of the crisis in 2008, the deterioration of this sector was continuous; from then to the second quarter of this year, its real value added posted a cumulative decline of more than 40%, far higher than that recorded by the market economy as a whole, which did not exceed 10%.

A major challenge facing the Spanish economy today is to have other industries, other than construction, take up the baton in terms of the creation of value added. And here, too, there are positive signs in recent quarters. The industrial sector achieved moderately positive growth in the second quarter, helped no doubt by the sound performance of exports. And the same occurred with the services sector.

Despite the containment of labour costs and while bearing in mind that the data show a less adverse trend in unemployment, this is the most serious of our macroeconomic imbalances and that showing most resistance to correction. Some analysts estimate – and at the Banco de España this appears to be a technically reasonable estimate – that, owing to the labour reforms, the economic growth threshold for job creation may have been lowered, which should impel the start of a correction in the unemployment rate with what are still moderate GDP growth rates.

As regards **private-sector debt**, Spanish households strongly increased their debt in the expansion preceding the crisis; their debt ratio rose from less than 70% of gross disposable income in 2000 to close to 130% in 2007 and 2008. Non-financial corporations moved on a

similar path, which lasted longer over time, with their debt ratio climbing from over 60% of GDP in 2000 to a peak of over 140% in 2010.

Here, too, there are signs of correction. Since 2010, households' and firms' debt has fallen by almost 10 pp and 20 pp, respectively. Admittedly, though, such restructuring is slow as a result of weak nominal growth in household and corporate income.

But the soundness of the recovery will unquestionably also depend on the progress made in **normalising financing flows**.

Since 2009, outstanding credit extended by our banking system to Spanish non-financial corporations and households has been contracting uninterruptedly. As at September 2013 it was 5.4% lower than a year earlier, but the decline was more marked for firms than for households: a decline of somewhat more than 9% for the former, and of 4.5% for the latter. As to firms, the reduction was more marked in the case of small and medium-sized enterprises (SMEs), whose access to other financing sources is generally more limited.

This fall-off in credit should be viewed set against the correction of the excess debt built up by Spanish households and firms during the expansionary phase that ended in 2008. Deleveraging has been necessary both on the part of lenders and of borrowers. But this credit contraction should also be viewed in relation to the end of the – what was unsustainable – expansion of the real estate development and construction sectors. And of no little importance, moreover, has been the re-drawing of the map of Spanish credit institutions – I refer here to the disappearance or transformation of many savings banks – which has, in a good number of cases, necessitated the re-configuration of relations between lenders and borrowers and has no doubt had a bearing on the funding difficulties experienced by viable firms with sound expansion projects.

For credit to flow normally again, two essential conditions must be met: economic growth must increase and the restructuring and recapitalisation of our banking system must – as is indeed under way – be completed. A strong, healthy banking system that acts transparently and offers full guarantees to depositors, borrowers and investors is an absolutely crucial condition for sustained economic growth and, therefore, for the correction of our very serious unemployment problem.

I must not fail to mention that, since May, the figures – including those relating to the use of Official Credit Institute credit lines – point to a less sharp contraction in lending to companies, a trend that is all the clearer if, along with bank loans, other channels of corporate financing, such as securities issues, are included.

In respect of the initiatives to promote an appropriate flow of credit to SMEs, which are so important throughout the European Union and, of course, in Spain, some of the ideas tabled are rather unrealistic, owing to their technical complexity, to political difficulties or to both. However, certain corrections that can make a positive impact are indeed possible.

On the national regulatory front, certain changes have been adopted. Further to Circular 4/2013, the Banco de España has revised the definition of SMEs, adopting the broader criterion recommended by the European Commission; moreover, with the entry into force in late September of the Entrepreneurs' Law, the discount factor applied to capital consumption envisaged in the new Basel III and European regulations has been introduced early.

I would also like to clarify that the contractionary behaviour of business lending at the aggregate level may prove and, indeed, is proving compatible with a reallocation of resources within the sector, meaning that the reduction in credit for some companies runs alongside an increase in credit for those which, in the opinion of credit institutions, are better placed to undertake profitable projects.

Precisely in relation to the recovery in credit flows, I will focus in the rest of my address on the task at the forefront of the Banco de España's priorities: **the reform and strengthening of our banking system**.

In 2012, in accordance with the regulations approved in the February–May period that year, banks undertook a major provisioning drive; and the Memorandum of Understanding and the financial assistance facility of up to €100 billion were negotiated with the European authorities.

The effort by banks focused, above all, on setting aside provisions to strengthen the coverage of loans to the real estate development and construction sector and of foreclosures. Moreover, in keeping with the Memorandum, banks under restructuring or resolution were obliged to transfer to Sareb, at an agreed price, the assets belonging to the above-mentioned balance sheets segments. As a result of this transfer, and bearing in mind the write-downs made, Spanish banks' exposure to these risks has been drastically reduced, from €240 billion as at end-2011 to €115 billion at end-2012.

Alongside the most notable clean-up and provisioning drive, a recapitalisation and restructuring strategy was applied based on the analysis of balance sheets and on the tests based on stressed macroeconomic scenarios which concluded a year ago. This was all done in collaboration with the European Commission, the ECB, the IMF and the European Banking Authority, in the presence of independent consultants and auditors, and with the participation of the Banco de España supervisory and regulatory teams, which was technically very important for the performance of the exercise.

The recapitalisation of our banks has been carried out through private access to markets; the injection of capital financed via the financial assistance programme agreed with the European authorities; the conversion of hybrid instruments into capital instruments; and the provision of funds by the FROB (Fund for the Orderly Restructuring of the Banking Sector) and the Deposit Guarantee Fund.

From May 2009 to last September, the public assistance afforded to financial institutions to reconstitute their capital amounted to a somewhat over €61 billion (6% of our 2012 GDP), close to €39 billion of which were under the Financial Assistance Programme approved with the European authorities in July 2012.

The essential aim of these recapitalisation operations using public funds has been none other than to preserve the deposits in the institutions in question (as is widely known, these are the only bank liabilities not to have undergone any loss throughout the process), providing for business continuity by these institutions' own means or by their absorption by others. This is a crucial point I wish to highlight, as it is not always well-understood.

Regarding transparency, I would signal the initiatives taken by the Banco de España, which have been favourably viewed by the European and international authorities and by the markets, on relevant exposures and refinanced loans. And mention should be made of the guidelines on accounting practices in respect of refinanced loans.

Finally, I wish to underscore the approval of Law 9/2012 of 14/2012 on the restructuring and resolution of credit institutions. To a most significant extent, this legislation stole a march on the future Directive that will regulate these processes in Europe.

Spanish banks' solvency position has improved clearly in 2013. The average core capital in our banking system will stand at around 10.5% as at December 2013, more than 1 pp above the related figure a year earlier. And, at the same time, exposure to the real estate sector has diminished drastically. Our banks may face the asset quality analyses and stress tests to be conducted by the ECB before the effective implementation of the Single Supervisory Mechanism in November 2014 from a sound position.

Conclusions

Allow me to conclude. With all due caution, the data available allow us to think that we **may** be at the start of an economic recovery in the EU and in Spain. This will never be

something mechanical, but rather the result of a major effort to correct the serious imbalances that our economy built up in the period to 2008.

The risks of this expectation not being fulfilled are not only and strictly in the economic sphere: legal security and political stability will be pivotal to the engine of recovery.

Thank you.