# Luis M Linde: The internationalisation of the Spanish economy

Testimony by Mr Luis M Linde, Governor of the Bank of Spain, before the Special Senate Committee for the Development of Internationalisation, Madrid, 2 June 2014.

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Ladies and gentlemen,

Allow me to begin by thanking Mr. Pío García-Escudero and the Chairman of this Special Committee, Mr. Iñaki Anasagasti, for the opportunity to participate in your work.

First, today, I shall set out some matters relating to the internationalisation of the Spanish economy and capital flows between Spain and the rest of the world. Next, I shall detail the main characteristics of the international trade financing structure and of the funding of longer-term projects. And finally, I shall review the characteristics of, recent developments in and regulatory treatment of such trade in respect of the remit of the Banco de España.

## Recent developments in the external sector of the Spanish economy

In the second half of 2013 a scenario of recovery began to take shape in our economy. A combination of several positive factors, both at home and abroad, has contributed to a situation in which Spain is beginning to overcome its second recession since 2008. The gradual improvement in GDP growth figures has been accompanied by a sustained correction of the main imbalances built up during the previous upturn. Progress here has helped Spain in ceasing to evidence excessive macroeconomic imbalances, in the opinion of the European Commission, expressed in the conclusions of the report it issued on 5 March as part of the European Semester. This is a positive result which should nevertheless not distract us from the need to continue adopting measures that further the correction of the imbalances still in place, even though appreciable progress is being made.

Of most visibility and weight has been the redressing of the external deficit. Following a deficit of 10% of GDP in 2007, the external balance posted a surplus of 1.5% of GDP in 2013. From the standpoint of its contribution to GDP growth, net external demand has substantially cushioned the fall-off in domestic demand.

The opening-up of our productive system to the external sector through trade flows and foreign direct investment is, as you know, one of the factors that has most boosted the modernisation of the Spanish economy in recent decades. The aggregate share of goods and services imports and exports from 1995 to 2013 has risen from 45% to 66% of GDP, outpacing countries such as France and Italy, although it is still some distance off those economies with greater export potential, such as Germany.

The buoyancy of Spanish exports has exceeded the increase in global trade. Our export share in the world total, in real terms, has increased over the past five years to around 2.2%, slightly above the relative weight of our economy in world output. This trajectory is all the more significant when compared with events in other developed economies and, in general, in the euro area as a whole, where export shares fell during the crisis.

Our sound export performance has been underpinned both by gains in competitiveness and the pick-up in external demand, as well as by more structural factors, allowing us to expect this potential to continue and become more entrenched in the long run. The structural factors include the geographical diversification of exports of Spanish goods and services to emerging markets and the more export-oriented gearing of our companies, which is reflected in the increase over recent years in the number of Spanish companies competing on international markets.

The re-directing of exports towards emerging markets has contributed significantly to these developments, thanks to the substantial dynamism of the demand for imports in those countries. Indeed, their dynamism has compensated for the cyclical weakness in the developed countries, particularly in the euro area.

The relative weight of goods exports to emerging countries has increased since 2007, coming to account for 30% of the total. The increases have been across the board, although particular mention may be made of Latin America, China and North Africa. However, the share of the developed countries has fallen on the same scale, owing to the loss in the weight of sales to the euro area, which at end-2013 stood slightly below 50%. In parallel, there has also been an increase in the variety of goods and services exported, with intermediate goods and services accounting for a growing proportion.

Since 2007 the number of Spanish goods-exporting companies has increased by more than 40%. And this despite the difficulties the international environment has undergone and the competition from the emerging economies. Moreover, the contribution of SMEs to this process is beginning to be significant.

A further reflection of the internationalisation of the Spanish economy in the past two decades has been its growing share in international direct investment flows, not only through foreign capital inflows, but also through investment by Spanish firms abroad. Spain has become a net issuer of direct investment, running counter to the historical pattern.

Large Spanish companies initially directed their foreign investment towards Latin America, diversifying subsequently towards the European Union. Currently, these two areas account for 50% and 30%, respectively, of total Spanish foreign direct investment in the rest of the world.

Direct investment flows into Spain, after having been interrupted at the height of the euro area financial market tensions in 2012, are regaining their pre-crisis levels. The gains in competitiveness and the reforms undertaken have no doubt increased the attractiveness of our economy to investors.

The headway made in the internationalisation of the economy against a particularly difficult background underscores the competitive capacity of part of the Spanish productive system. However, despite progress in recent years, Spain's share in some potentially very dynamic markets is still low and faces major challenges, in a world of growing competitive pressures and the globalisation of production channels.

Nor should it be forgotten that our economy's dependence on energy and capital goods imports and the high net payment of income to the rest of the world, as a result of high external indebtedness, are a permanent constraint as regards achieving the surpluses on current and capital account that are needed to deleverage our economy.

**Institutions and financial policy for the internationalisation of Spanish companies**

Internationalisation calls for a series of financial services in which the banking industry plays a central role. These services can be grouped into two major categories: operations geared to mitigating the risk of transactions, namely guarantees and insurance; and those geared to providing liquidity or financing to companies.

On the data available, regarding the importance of banks in financing international trade, banks participate directly in approximately ***one-third of global trade***.

On one hand they offer financing, usually short-term in nature, which responds to the exporter's or importer's liquidity or working capital needs. They also offer coverage for risks through guarantees or insurance, ensuring the successful completion of transactions for the customer. Moreover, the extension of coverage for credit risk facilitates – albeit indirectly – access to financing by reducing risk on the company's balance sheet and, consequently, reducing the financial cost of the transaction.

The ***remaining two-thirds*** of the financing of international trade are covered through inter-company credit, without the direct involvement of banks. Nonetheless, these transactions might be indirectly backed by the banking sector, for instance through the discounting of bills that enables the company to obtain financing by using its customer trade receivables.

The instruments used by banks to finance international trade share certain characteristics. They are short-term instruments with low credit risk (low default rates) and are non-renewable.

Notable among these instruments are pre-export credit, which allows the exporter's production or transport costs to be covered, and export loans, whereby companies obtain short-term financing to cover financing needs in the event of deferred payment by the supplier.

Also of note is the recent securitisation of assets linked to international trade financing. Securitisation is a habitual practice in the finance industry, but its application to these assets is quite new. By means of such securitisation, banks release capital and liquidity while non-bank institutions are able to invest in international trade-related securities.

Asset securitisation has been regulated in Spain since 1981, but the developments aimed specifically at promoting securitisation linked to the financing of foreign trade are much more recent. "Internationalisation covered bonds" were introduced by Royal Decree-Law 20/2012 on 13 July 2012, and in Law 14/2013 of 27 September 2013, on support to entrepreneurs, this legal framework was amended with a new instrument, namely "internationalisation bonds". Unlike covered bonds, the latter are backed by packages or specific groups of foreign trade financing operations. These new bonds may contribute to reducing exporting firms' financial costs and to increasing the total volume of financing.

Along with providing financing, banks also extend coverage for export risks, relating for instance to the recipient country's economic or political situation, so-called "country risk"; the risk that products may be damaged in transit or withheld at borders; collection difficulties in the event of non-payment, associated with different jurisdictional frameworks; and greater uncertainty in the relationship between the supplier and acquiring company.

Banks have used various instruments to extend guarantees on international trade flows.

The classic instrument is, of course, the documentary credit. The importer's bank guarantees the exporter's bank that payment will be made once it has been confirmed, through presentation of the pertinent documentation, that the transaction has been correctly completed. In this way, exporters notably reduce their risks.

Naturally, the demand for coverage of credit risk is higher for trade flows with countries with which there are fewer historical ties and with those trade partners for which greater risk is perceived. Accordingly, this may prove important in the opening-up of new markets and in flows to emerging economies.

As regards the medium and long term, the nature and functioning of transactions differ from those for short-term transactions. The financial services provided by banks for longer-dated terms are, essentially, financing and the extension of guarantees and bonds needed to participate in international tender procedures. On many occasions these are syndicated operations, or operations performed by several banks from various countries.

We should highlight here the role played by export credit companies. This activity is subject to the rules set under the OECD Arrangement on Officially Supported Export Credits, or the OECD Consensus, as it is usually called.

**The OECD Consensus**

The OECD Consensus, signed in 1976, has regulatory status in the European Union and seeks to prevent financial facilities granted by a State to an exporter from distorting competition and giving an exporter an unfair advantage against competitors from other countries. The Consensus also works on the assumption that official support is warranted only if there is a "market failing" that prevents the private sector from properly meeting its task as a financier. The Consensus sets common rules for exports in the medium and long term, understanding as such terms over two years, and specifies that official support may take the form of either direct public financing of the export, or the underwriting by the public sector of the refund of the export financing granted by private institutions.

In Spain, CESCE (Spanish Export Credit Insurance Agency) pursues its activity on behalf the State, complementing that of the banking system. Among its operations, what affords the greatest value added is the coverage of credit risk arising from a Spanish export, of a relatively high amount, at a term of over two years, habitually financed by a bank. Such coverage is the norm for exports towards countries with appreciable risk and in transactions which, frequently, have the sovereign guarantee of the importing country.

CESCE also provides underwriting on the State's behalf for the political risks associated with exports (the main such risk being default by the sovereign or by the institutions backed by the sovereign), except in operations at less than two years in EU and OECD countries, where it is considered that there is a sufficiently developed private underwriting market; it also extends guarantees and bonds for participating in international tender procedures and projects.

From 1998 to 2007 there was a strong expansion in international banking activity in financing for Spanish companies' international activity. Banks took on a relevant role in the financing of trade flows to emerging countries and in the opening-up of new markets.

Against the backdrop of this boom, the use of instruments offered by export credit agencies for exports became less necessary and less frequent.

## The international financial crisis

The financial instability as from mid-2007 and the outbreak of the crisis in autumn 2008 radically altered this financial landscape, giving way to an across-the-board decline in financing by international banks. The contraction in credit had a particularly severe effect on international trade, which fell by between 20% and 30% in the main economies.

The central banks responded to this situation through coordinated action that stabilised bank financing conditions. The measures included most notably the currency swap lines opened by the Federal Reserve and the main central banks, including the Eurosystem, which helped ease the shortage of dollars. The G-20 also launched initiatives to raise funds for the financing of international trade and to increase the funding of multilateral development banks.

Export credit agencies and their countercyclical measures contributed to easing the problems. Against a background of high uncertainty, exporters sought to guarantee with hedging instruments operations for which previously they required no insurance whatsoever, but the supply of private financing was strongly depressed and its cost rose notably.

The difficulties of raising external wholesale funding and the need to shore up their solvency ratios led Spanish banks to reduce their financing for export transactions. The impact on medium- and long-term transactions (those CESCE could insure) was notable. Hence, CESCE's activity declined given that without financing there can be no insurance.

The risk perceived by foreign institutions in their transactions with Spain also increased. This led to a squeeze on the financing provided by some foreign banks, reflecting Spain's sovereign downgrade. The increased risk perception lessened foreign banks' capacity to accept guarantees from Spanish banks, even in the short term. As to the long term, foreign banks restricted guarantees to Spanish companies to participate in international tender procedures, or more generally, the financing of Spanish companies' long-term projects.

The tensions eased through various channels, among which the activity of CESCE, which bolstered the extension of guarantees and bonds to Spanish companies to participate in international tender procedures and projects.

## Regulation by the Banco de España

The Banco de España, in the performance of its functions, lays down a series of accounting and prudential rules that determine the requirements made of banks in the pursuit of their activity. These rules comprise the regulatory implementation of Spanish legislation which, in turn, is determined by European regulations and by the agreements reached on the Basel Banking Supervision Committee.

Let me begin with accounting regulations and, in particular, with the rules on country risk provisions, which are particularly significant in international trade transactions.

In these financing operations there is, alongside the risk of commercial insolvency, so-called country risk, which includes, by way of sovereign risk, transfer risk (i.e. that it is not possible to meet debts abroad owing to a lack of currency or the legal impossibility of transferring currency) and other risks arising from international financial activity, such as expropriation and natural disasters. As what is involved is a risk other than habitual commercial risk, it requires a differentiated treatment under default provisioning rules.

These rules set provisioning percentages based on risk and criteria so that banks may make an assessment of country risk by monitoring economic developments and the political and institutional situation; further, they contain exemptions arrangements, with such exemptions depending on the type of transaction, its term and the modus operandi. Notably, these rules do not affect foreign direct investment by the Spanish financial system, since they do not apply to debt instruments and to contingent risks, nor to risks vis-à-vis European Union countries.

The impact of these rules on foreign trade is low since most trade finance products are not subject to country risk provisioning. Trade credits with a maturity not exceeding one year are exempt, as are pre-financing credits with a term equal to or less than six months for specific export agreements.

The rules also provide for an exemption for CESCE insurance operations, which is an added incentive for banks to have this guarantee in medium- and long-term transactions since, in addition to eliminating default risk, they do not then have to set aside country risk provisions.

The prudential treatment of instruments supporting internationalisation and, specifically, of instruments linked to short-term trade transactions draws on two significant regulatory frameworks: Basel III, at the international level; and the Regulation (which is directly applicable in all Member States) and the Directive on prudential requirements and their attendant supervision, drafted within the European Union, namely Regulation (EU) No. 575/2013 on prudential requirements for credit institutions and investment firms, which is directly applicable throughout the EU, and Directive 2013/36/EU on access to the activity of credit institutions and their prudential supervision. This latter Directive requires, in turn, national transposition.

The three major avenues of regulatory reform under Basel III and their transposition to the European legislative framework, with consequences for foreign trade-related transactions, are the treatment of credit risk for solvency purposes, the leverage ratio (the ratio of top-quality capital to total assets) and liquidity ratios. The discussions on solvency have been concluded, while certain aspects of the leverage and liquidity ratios remain subject to review.

As regards the treatment of credit risk, Basel III recognises a lower foreign trade financing risk than Basel II. As a result, the consumption of capital in these transactions is lower than in other analogous short-term financing transactions. These changes have been transposed into European prudential regulations.

Lastly, in connection with liquidity management and supervision, the Basel Committee (and, to a greater extent, European legislation) has incorporated into the determination of the short-term liquidity ratio a specific treatment for foreign trade-related transactions with a residual maturity of 30 days or less. The potential adverse effect on the availability of financing for foreign trade derived from the obligation to maintain sufficient, quality liquid assets is thereby mitigated.

In an economy with a developed banking system such as ours, financing for the internationalisation of the Spanish economy is largely conditional on developments at the international level. The best policy for promoting the financing of the international expansion of our companies is to ensure the financial stability and soundness of the Spanish financial and banking system.