Luis M Linde: Overview of the Spanish economy and progress on banking union in Europe

Testimony by Mr Luis M Linde, Governor of the Bank of Spain, before the Parliamentary Budget Committee in connection with the draft State Budget for 2015, Madrid, 1 October 2014.

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Ladies and gentlemen,

As is habitually the case, my appearance before this Committee at the start of the parliamentary process to discuss and approve the Budget will focus on the developments in and the outlook and challenges for the Spanish economy, which are the framework for economic policy measures. On this occasion I shall also refer, at the end of my address, to the progress on banking union in Europe. As you know, the Single Supervisory Mechanism will begin to operate in early November, marking a milestone on the road taken to overcome the fragilities in the architecture of the European Monetary Union.

The external setting of the Spanish economy

I shall begin with a reference to the external setting of the Spanish economy and to the monetary policy we share with the euro area countries.

The world economy remains on a course of progressive recovery which, on available forecasts, could place GDP growth at a rate of around 3.5% this year, and closer to 4% in 2015.

The performance of the different global regions remains, however, very uneven. While recovery is firming in the United States and in the United Kingdom, the Japanese economy appears to be losing momentum. A lack of dynamism is even more evident in the euro area, where growth forecasts have been revised downwards and point to a very weak pace of recovery. Among the emerging economies, growth continues to be high in Asia, in contrast to the poorer performance of some Latin American economies.

At the global level, inflation continues to hold broadly at moderate levels and no significant inflationary pressures are discernible. This behaviour of prices justifies keeping monetary policy loose in the advanced economies, in line with the stance adopted at the start of the crisis. Nonetheless, in the United States and the United Kingdom, where recovery is moving more briskly, we are already witnessing the first steps of the withdrawal of the exceptionally expansionary, non-conventional measures introduced at critical junctures of the crisis. But we cannot yet refer to a change in tack in the monetary policy stance of these two countries. Rather, what is involved is an incipient return to a somewhat more neutral monetary stance. And as these countries' central banks have insisted, the change will be gradual and in step with the progress of each economy so as to avoid jeopardising the recovery.

The conduct of the Federal Reserve and the Bank of England is in significant contrast to that of the European Central Bank, which currently faces a very different growth and inflation scenario.

The fragile recovery that began around mid-2013 in the euro area has progressively lost momentum in 2014. Indeed, GDP in the area was flat in the second quarter of this year, although this figure reflects transitory factors whose influence is still difficult to assess. In any event, most analysts predict weak growth in the euro area both this year and next, with highly uneven rates across countries and significant downside risks.

Euro area inflation is ultimately moving at figures far removed from the 2% reference which, in the medium term, is the monetary policy objective for the area. With inflation rates

standing roughly at scarcely 0.5% and a macroeconomic scenario marked by sluggish demand, the dangers of a downturn in inflation expectations have become increasingly more patent, increasing the risks to recovery.

The European Central Bank has responded to these risks with additional measures that have further accentuated the expansionary nature of euro area monetary policy, thereby placing itself apart from the trajectory initiated by the Federal Reserve and the Bank of England. At its June and September meetings this year, the ECB Governing Council adopted an array of expansionary measures which, once again, combine conventional and other exceptional and unconventional actions.

On the conventional front, the ECB once again reduced its official interest rates. The main refinancing operations rate was cut to 0.05%, a level which technically marks the minimum possible bound for this type of interest rate. The marginal credit facility and deposit rates were cut by a similar amount (10 basis points) to stand, respectively, at 0.30% and –0.20%. This further cut to the negative deposit facility rate increases the incentive for banks not to hold immobilised surplus liquid balances in their accounts with the Eurosystem.

In the non-conventional arena, the ECB has set in train a new long-term refinancing operation explicitly geared to make lending to the private sector more buoyant. These operations, which will be launched from September this year to June 2016, may have a term of up to 4 years, at a very attractive cost for banks: 10 basis points above the main refinancing operations rate, which is equivalent at present to only 0.15%.

Given that the aim of new long-term injections is to stimulate bank loans to the non-financial private sector, their availability has been linked to both the stock and the flows of lending extended by banks to households and firms, although loans for house purchase have been excluded from these calculations.

The non-conventional measures agreed in September also include two new asset purchase programmes, the details of which will be addressed in the next ECB Governing Council meetings.

The Eurosystem may acquire financial instruments derived from securitisations that meet various requirements. They must be simple, transparent and based on loans to households and firms in the euro area. The programme is expected to be able to contribute to reinvigorating the securitisations market, a major market that has been greatly affected by the crisis.

Furthermore, this month the Eurosystem will set in motion a new programme to purchase mortgage-backed securities, or securities backed by other loans held by banks, i.e. in Spain's case, our various types of covered bonds.

Following the approval of this set of measures, the ECB has reiterated its commitment, unanimously backed by its Governing Council, to resort if necessary to further unconventional measures.

Developments in and outlook for the Spanish economy

In contrast to the weakening of the recovery in the euro area, the momentum of the Spanish economy in 2014 has progressively firmed. GDP rose in the second quarter by 0.6%, marking four consecutive quarters of increases. The latest figures point to this trajectory continuing over the rest of the year, albeit at a more measured pace. That will allow the year-on-year rate of change in GDP to draw close to 2% in the final quarter, a rate at around which the Spanish economy may be expected to grow on average in 2015 as a whole.

The growth rate of employment during the first half of the year exceeded forecasts across the board in the productive sectors, albeit more intensely so in market services. Our expectation is that this pattern of job creation and of gradual reduction in the unemployment rate will continue, although perhaps somewhat more slowly.

National demand is playing a key role in this phase of recovery. Among the factors driving it are, first, the progressive normalisation of financial conditions brought about by the Eurosystem's expansionary monetary policy and the reduction in the degree of financial fragmentation in the area. Favourable labour market developments are also playing a notable part in kick-starting domestic demand, by contributing to upholding household disposable income and to improving confidence.

Among the domestic spending components, mention should be made of household consumption (underpinned by improved disposable income and by recourse to saving), the sustained increase in business investment (driven by brighter final demand prospects) and the culmination of the sharp adjustment of residential investment, where there are signs of stabilisation. For the first time in the last six years, close-to-zero or slightly positive rates can be observed in the aggregate real estate price indices.

Lending figures remain in a contractionary phase, in parallel with private-sector deleveraging. But, on the data available, this process is proving compatible with a shift in credit flows towards companies with better output and export prospects and in a sounder financial position.

Foreign trade flows have undergone quite sharp changes in 2014, brought on by the loss of momentum in our export markets (most particularly in specific emerging economies and in the EU) and the acceleration in imports as the recovery took root. As a result, the net contribution of the external sector to GDP has diminished and the pace of adjustment of the external imbalance has slowed. While some of these developments are conceivably temporary, the high cyclical sensitivity of our imports alerts to the need to broaden our export base and to continue increasing the presence of Spanish companies in markets with greater growth potential. It is also an indicator of the problems our competitiveness poses not only for exports but also, domestically, with regard to imports.

On a par with other euro area countries, Spain's inflation rate is trending extremely moderately. In the summer months the year-on-year rate of change in the CPI turned negative (-0.2% in September) owing to the influence of temporary factors that affected the prices of unprocessed food and energy products, following marked increases in 2013. That said, core inflation has posted practically zero growth since the start of the year, suggesting there are other, more persistent factors making for a greater sensitivity of costs and prices to the need for the economy to adjust. At the end of the year the inflation rate is expected to return to positive – though very low – values.

Fiscal policy

Such is the macro-financial setting in which the State and Social Security Budget for 2015 has been drafted.

The scenario is more favourable than in previous years, which should help us to continue the fiscal consolidation process. The improved cyclical position and the significant reduction in the risk premium and interest rates on public debt have a major direct positive effect on public finances, in contrast to the adverse pressure wielded by these variables in recent years.

The adjustment in public finances undertaken by the Spanish economy is three-pronged: the gradual reduction in the budget deficit in line with the targets set, the strengthening of the fiscal governance framework and the reform of the pensions system.

In light of the budgetary exercise under way, compliance with the fiscal commitments acquired at the European and national level should be the cornerstone of our budgetary policy. Fulfilment of these objectives will allow us to build on the gains in credibility already attained and to turn around the upward trend in the public debt/GDP ratio. Both goals are prerequisites for a durable economic recovery.

One of the main changes to the institutional framework of Spanish fiscal policy has been the creation and start-up of the Autoridad Independiente de Responsabilidad Fiscal (Independent Authority for Fiscal Responsibility – IAFR).

The IAFR will be playing a most prominent role throughout the budgetary cycle, monitoring compliance with the principle of budgetary stability in the general government sector, in accordance with the provisions of Article 135 of our Constitution and with European regulations. In this way Spain is moving to enhance its economic governance, joining those EU countries – practically all of them – that have this type of agency.

The IAFR, adhering to the principles of independence, transparency and accountability, will contribute to improving control over fiscal policy and to introducing greater budgetary discipline in all tiers of general government, in line with the Law on Budgetary Stability and Financial Sustainability approved in 2012.

More specifically, and focusing on the budget for this year, the IAFR has recently published a report on macroeconomic forecasts *(Informe sobre las Previsiones Macroeconómicas)*, endorsing the Government's macroeconomic projections that underpin the draft State Budget and analysing the consistency of the projections made in previous years. Furthermore, by 15 October, the IAFR is to publish its report on the draft Budget *(Informe sobre el propio Proyecto de Presupuestos)*, in which it will assess its suitability with a view to meeting the objectives of stability, debt and the rule that ties spending to economic growth.

As regards the sustainability of public finances in the long term, the latest key development has been the approval and entry into force of the new revaluation index and the pension sustainability factor. The reform entails a structural change, since benefits are to be linked to the system's ability to generate revenue.

The information available on the budget outturn to date this year shows headway in the process of fiscal consolidation. The overall general government deficit in National Accounts terms was 3.43% of GDP to June, 0.5 pp down on the figure of 3.94% in the same period a year earlier. The central government, Social Security and regional government deficit to July stood at 3.87%, compared with 4.41% in 2013. Attaining the projected deficit of 5.5% to 2014 as a whole will require sustaining the pace of adjustment in the second half of the year.

The draft State Budget for 2015 sets a budget deficit target of 4.2% of GDP, 1.3 pp of GDP below that for 2014. Given the improved macroeconomic situation, the fiscal drive required to attain this reduction, measured by the change in the primary structural balance, will be more moderate than in previous years.

In the case of the State, and according to the information from the draft Budget, the planned reduction in the deficit is based primarily on public spending, whose ceiling for the year as a whole has been set at a level 3.2% lower than in 2014. Measures envisaged include most notably those relating to personnel expenses, with the wage freeze on public-sector employees continuing, although one-quarter of the 2012 "extra" payroll payment is to be returned to them, and there is to be an increase in the average staff replacement rate to 50% for the health care, education and security sectors, among others.

As to revenue, the projections include the estimated impact of the recently approved tax reform. In the next two years, this reform will specifically entail a gradual reduction in personal income tax and in corporate income tax. The budgetary cost of this reform will be relatively lower in 2015, although it will have a greater impact, naturally, once it has been set fully in place. The budgetary projection indicates that this forgone revenue will be offset by the greater buoyancy of revenue against a background of strengthening recovery, particularly in domestic demand.

The uncertainty habitually clouding estimates of the impact of tax changes will require a continuous monitoring of revenue-raising in 2015 so as to head off potential slippage and, where appropriate, to react in time so as to prevent such slippage from adversely impacting budget deficit targets.

The public debt/GDP ratio will continue on an upward trend, until reaching 100.3% according to the official forecast. The scale of this figure highlights the challenge facing budgetary policy in Spain, which will have to continue prioritising the gradual reduction of this debt.

Outlook and challenges

The outlook for the Spanish economy is brighter than that which I outlined to this Committee a year back. The rebalancing of domestic expenditure and net external demand has continued, with greater vigour than was previously expected. The pick-up in employment is proving to be one of the main drivers of domestic demand, attesting to the role that the labour market reform and wage restraint are playing in entrenching the recovery, although unemployment remains unacceptably high.

But this scenario of recovery is not free from risks. Some, particularly those stemming from the external environment, have increased in recent months. Others are related to the effects of the crisis on the real and financial position of households and firms in a setting in which private-sector deleveraging and fiscal consolidation must continue.

The start-up of the SSM, the assessment of significant institutions and the new European resolution authority.

As earlier stated, I feel bound to refer to the imminent start-up of the Single Supervisory Mechanism.

Further progress has been made in recent months on the project to create a banking union. As we know, this project is vital to ridding Europe of the financial fragmentation which, at the height of the crisis, jeopardised the very survival of the euro and which has affected economies such as Spain so adversely.

I shall broach three issues: the Single Supervisory Mechanism; the assessment of the solvency and soundness of the European banks directly supervised by the ECB; and, thirdly, the Single Resolution Mechanism.

1) The first pillar of the banking union is the Single Supervisory Mechanism, whose aim is to improve supervision in the euro area and make it more uniform, to promote financial integration and to break the negative link between confidence in banks and doubts over the sustainability of public finances.

Since the approval by the European Council of the SSM Regulation, in October 2013, work has proceeded apace to ensure the SSM commences operating on 4 November. In particular, the ECB has approved a Framework Regulation which defines the supervisory function, its attendant arrangements and the distribution of responsibilities between the ECB and the national authorities. Further, a new Guide to Banking Supervision has been drafted, setting down the procedures all SSM members are to follow.

The SSM has been defined as an integrated system of bank surveillance, which will combine the leadership of the ECB with the active participation of national supervisory authorities. In any event, arrangements are in place to ensure that the assumption of these new functions by the ECB will not clash with its monetary policy responsibilities.

As of June 2014, total euro area bank assets amounted to €26 trillion. Given the very high number of credit institutions (some 3,500) established in the euro area, the SSM regulation draws a distinction between “significant” institutions, which will be supervised directly by the ECB, and “less significant” institutions, which will remain the responsibility of national authorities and which the ECB will indirectly supervise.

Finally, a list of 120 significant institutions has been drawn up, 15 of which are Spanish (14 once a merger currently under way has been completed), accounting for just over 90% of the assets of deposit institutions in Spain.

The 120 "significant" institutions represent 80–85% of total euro area bank assets; the Spanish banks that will be directly supervised by the SSM account for 14% of the total assets of these 120 significant institutions.

2) In recent months, as a prior step to the SSM taking over supervisory competences, an assessment has been made of significant institutions, the aim of which is to enhance transparency in respect of their position and to reinforce their solvency. The outcome of this exercise will help the SSM to assume its functions with accurate knowledge of the actual situation of the banks it will directly supervise.

The exercise is now close to completion and its results will be made known before the end of this month. It comprises two phases: an asset quality review and a stress test, on which the Banco de España has been working intensely for several months in cooperation with the ECB.

The first phase, namely the assessment of the quality of the assets associated with credit and market risk, consisted of verifying the accuracy of the figures and of reviewing asset and collateral values, along with the related provisions (with the collaboration of audit firms). On the basis of the results obtained, exposures have been classified as standard or non-performing, based on the level of risk, with the ECB imposing painstaking quality control of the results of the review.

A stress test is an analysis of credit institutions' capacity to absorb losses, evaluating their resilience in different scenarios. The exercise indicates how much capital might be needed were risks to materialise, and it helps highlight areas where supervisory action might be necessary.

The position of banks is evaluated in two scenarios: a baseline scenario, taking as its starting point the European Commission's forecasts, and an adverse scenario, approved by the European Systemic Risk Board, the European Union's macroprudential surveillance body headquartered at the ECB. The stress test horizon of three years (2014–2016) is formulated using banks' consolidated balance sheets at the close of 2013.

Minimum thresholds have been set that banks must meet in respect of core capital, according to the Basel III Accord. These stand at 8% for the asset quality review exercise and for the stress test baseline scenario, and at 5.5% for the adverse scenario. Those banks below these thresholds will have two weeks to submit capital-raising plans, which should envisage coverage of the shortfalls identified. They will have ***six*** months to cover capital shortfalls identified in the asset quality review and in the baseline scenario of the stress tests, and ***nine*** months to cover shortfalls estimated under the adverse scenario.

3) Allow me to refer, finally, to the Single Resolution Mechanism.

Political agreements were reached last May between the European Parliament and Council to set up this Mechanism, comprising a network of national resolution authorities, the new Single Resolution Board and the Single Resolution Fund. The Regulation creating the Single Board and Fund was published on 30 July; since then work has continued on the elements that will enable the Mechanism to come on stream on 1 January 2015.

The Single Board will have competence over the resolution of the most important institutions, namely the significant banks overseen by the SSM, and will be empowered to use the resources available in the Single Resolution Fund. In addition, it will set criteria and oversee the measures implemented in this area by national authorities in connection with the remaining banks. The Fund will draw on contributions from all the banks of the countries participating in the new Mechanism.

Conclusions

To conclude, allow me to draw my address together in three points.

Firstly, the Spanish economy is in a phase of recovery, meaning not only more activity, but also progress in the correction of the major imbalances built up during the previous upturn: the budget deficit, unemployment and private-sector debt.

Secondly, there are risks currently stemming, above all, from the international economy, and particularly from the euro area, which may affect this recovery.

And thirdly, progress is being achieved in European economic governance, in particular in the banking union, which we all hope will contribute to alleviating and ultimately eliminating financial fragmentation, and to shoring up the complex institutional arrangements that are the basis of the Monetary Union within the European Union.

Thank you.