

Barcelona, 3 June 2008

Speech by the Governor

2008 International Monetary Conference – Central Bankers Panel

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Ladies and Gentlemen,

I would like to thank the International Monetary Conference for inviting me to participate in today's Panel. We meet at a moment when we are confronted with particularly difficult challenges, in the wake of substantial economic shocks.

I would like to take advantage of the opportunity to comment on these challenges from the Spanish perspective. I will first focus on economic developments, and then turn to the financial sector.

The Spanish economy began to show some signs of a slowdown in early-2007, after more than a decade of robust expansion.

The slowdown preceded the recent financial turmoil. The deceleration in domestic demand arose as a result of the gradual tightening of monetary policy since 2005, and of a moderation in house prices. The residential investment sector has suffered a particularly intense slowdown, entering into a period of adjustment after a protracted boom. The containment of domestic demand has been more pronounced since mid-2007, when the turmoil emerged.

The slowdown has eroded consumer and business confidence. It is already having an impact on the spending decisions of households and firms. We are seeing signs that credit conditions are tightening, as a consequence of the reappraisal of risks and changes in macroeconomic and sectoral expectations.

In this context, we expect internal demand to continue weakening over 2008. Indeed, the most recent economic projections released by the Bank of Spain show reduced GDP growth in 2008 and 2009.

At the same time as we face a slowdown in growth, we are seeing sharp increases in headline inflation. These have been driven by large energy and food price rises at the global level.

The price boom has affected Spain to a larger extent than some other countries, partly due to the higher relative weight of these items in household expenditure. And the Spanish economy may be more vulnerable than other countries to second-round effects due to the widespread existence of indexation mechanisms.

I would like to make a few comments about what economic agents should and should not do to face these challenges.

On inflation, the key issue is how firms and workers respond to the recent shocks. I would like to make two points:

- First, firms should not view the shocks as permanent. In other words, they should not consolidate price-rises over the longer term.
- Second, workers should understand that inflation cannot be offset by demanding wage increases that are not justified by productivity developments. This would just keep inflation persistently high, as the 1970s experience painfully showed.

From the perspective of GDP growth, if we are to see a quick return to our potential, we need flexibility in supply and demand responses. We need to see increased dynamism, particularly in those sectors which are not as directly affected by the current slowdown.

Other measures are also necessary, such as liberalisation and deregulation policies, to improve competitiveness. Policies aimed at improving the human capital of our workers and increasing labour mobility should also be encouraged.

Finally, a comment on fiscal policy. The current fiscal situation in Spain is sound, having ended 2007 with a budget surplus and reduced public debt. Indeed, let me recall that our public debt to GDP ratio, at 35%, is the lowest among the big EU countries. It is important to maintain this stance in the face of the current slowdown. Expansionary demand policies could prove counter-productive. We should avoid a deterioration of the budgetary situation beyond that implied by automatic stabilisers.

Let me turn now to the financial sector. So far, the impact of the recent turbulence on financial stability in Spain has been limited. This is largely thanks to the actions of the banks themselves, who have not entered into the kinds of business that have been most directly affected. Spanish banks have demonstrated that you do not need to turn to the originate-to-distribute model to become an efficient and profitable banking business. Plain vanilla, traditional business can be compatible with high returns on equity and efficiency. It also has the added value of implying greater stability. But I think that the Bank of Spain's approach to supervision has also had a positive effect. Let me emphasise two key characteristics in this respect.

- The first characteristic, which has set us apart from other supervisors, has been our strong role in accounting rule-making for the banking sector in Spain. This has meant that the accounting rules for the banking sector take into account supervisory sensitivities, whilst being also consistent with IFRS. One example of this is the so-called "dynamic provision", which we introduced in 2000. This allowed Spanish banks to build up a significant provisioning buffer in a transparent manner, to be used in bad times, when problem loans increase. In 2005, the Bank of Spain reformed the dynamic provision when adopting International Financial Reporting Standards. Despite the reform, banks kept the strong provisioning level set by the former rules, and today they face the current situation with a

sound buffer of loan loss provisions (1.3% of total assets at the end of 2007, and this despite bad loans being at historically low levels).

- The second characteristic that has proved useful is the Bank of Spain's prudent approach to bank regulation. One example has been our stance on off-balance sheet investment vehicles. We have not prohibited the development of investment vehicles, but we told banks that if they set up Special Investment Vehicles, these should be consolidated with the group, and therefore be subject to capital requirements and provisions. Under these conditions, no such vehicles were set up. As a consequence, the Spanish banking system has not been so seriously hit by the de-leveraging process as other systems that have a freer attitude towards these vehicles.

Furthermore, securitisation in Spain has mainly been used as a financing tool, to raise resources on the wholesale financing markets in order to meet the demand for loans from households and businesses. Since the element of credit risk transfer was limited, Spanish banks have had little incentive to issue overly complex financial instruments. Furthermore, we have always required capital to be held against liquidity enhancements to securitizations, which we consider may have significant credit risk.

Let me take this opportunity to make a brief observation on the securitisation sector, which some have described as being in "dire straits". I am sure that this sector will ultimately recover. But to do so, it must distinguish between traditional products that are sound, transparent, standard and easy-to-value, and "multi-layer" securitisations and complex structured products which are difficult to understand and assess. The good news is that the market is starting to differentiate between products. An example of this is the recent placement of several Spanish banks' issues of simple covered bonds.

In short, our recent experience shows that to be successful supervisors we need to combine an open attitude to financial innovation whilst keeping at the same time some good old fashioned supervisory suspicion towards it, especially when it entails overwhelming complexity or elements of regulatory arbitrage.

The Spanish banking system has faced the recent turmoil from a well-capitalized, profitable and efficient position. However, there is no room for complacency. In today's global financial system, the Spanish banking system is not immune to problems if serious global macroeconomic imbalances materialise or if the current situation persists. Banks' managers and directors alone are responsible for running institutions and for their results. But central banks and bank supervisors must rise to the challenge and collaborate closely with each other so as to help return stability to the global financial system.