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Opening Address by Governor Miguel Fernández Ordóñez

Banco de España Seminar - Spanish Day. ADB Annual Meetings

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Good morning ladies and gentlemen,

I would like to welcome the participants in the Asian Development Bank Annual Meetings to the Seminar organised by Banco de España on the occasion of the Spanish Day of this year's Meetings, which conclude today. I hope that you are enjoying your stay in Madrid.

I also hope that, after so many interesting meetings and discussions we will be able to provide you with new food for thought. The stakes are high, but I think that the topics selected for the two sessions of this Seminar and the distinguished panels of participants will be up to the challenge.

Indeed, I am convinced that the discussions this morning will raise a number of interesting reflections. They should help us frame a better understanding of the important economic and financial challenges facing a region like Asia, which has become increasingly relevant for the world economy. Specifically, the aim of the Seminar is to reflect on how the financial system can be an instrument to rebalance and foster growth in the region. In this context, I believe that the Spanish experience on banking system restructuring –which is widely viewed as a success story- can provide some interesting lessons.

I would like to take this opportunity to make some remarks on these two issues, but let me start first with some considerations on the developments, outlook and challenges of Asian countries in the context of the present financial turbulence.

Notwithstanding the cloudy and uncertain outlook we face now, global economic activity held up extremely well in the course of 2007. World growth reached almost 5%, completing the four-year period of highest growth since the sixties. Industrial economies grew near 3% last year, whereas emerging markets crucially contributed to this extraordinary performance recording an impressive 7.5% annual rate of growth. Taking into account their increasing weight in the global economy, this means that emerging markets explained more than two thirds of the global growth in 2007. Emerging Asia was a key contributor to this buoyant performance of emerging markets with an increase of GDP of almost 9%, driven by the two largest economies in the region: China and India. China's expansion of over 11% explained 25% of total world growth and India close to 9%. As I will develop in a few minutes the growth performance of these two countries is a key factor to assess the global perspectives.

Where are we now? This year has started on a rather slow motion and the mood is far from positive. The economic and financial strains in the US and their spillovers to other advanced economies are dragging down global economic forecasts. Even in Japan, where the direct impact

of the turmoil has been relatively contained, the economy remains fragile and prospects have deteriorated.

The emerging market economies stand in sharp contrast with this gloomy outlook, as their growth forecasts have been revised down only marginally. In fact, one of the most surprising features of the recent developments in the world economy has been the resilience of most emerging market economies to the unravelling of the global turbulence. This feature is even more remarkable taking into account their recent history of financial and economic instability.

If we look at basic financial market indicators of risk --such as the sovereign spreads, exchange rates or equity markets-- what we observe is that, overall, they have behaved significantly better than comparative asset classes in the industrial economies over the past nine months. In addition, credit has generally continued to be available in these economies --albeit, admittedly, at a somewhat higher cost- and creditworthy emerging market borrowers have not been shut out from international markets, contrary to what used to happen in the past.

It is true that issuance abroad has been reduced notably since the beginning of the turbulence, and that those borrowers with relatively low credit ratings may have been shut out completely from international markets. However, anecdotal evidence indicates that they have been able to substitute their sources of finance by shifting into bank loans, something that can also be seen as a positive feature of the functioning of financial markets. In fact, the limited transmission of the turbulence through the financial channel is the key difference with the past.

More precisely, what has made the emerging markets so resilient this time? The answer is the building up of strengths, not only in Asia, but also in Latin America and in Emerging Europe. On the one hand, growth has become more broad-based and with a much stronger contribution of domestic demand, in other words, more self-sustainable. In addition, south-south and intra-regional trade linkages among emerging economies have increased. This has mitigated potential trade spillovers from industrial economies, although it has not suppressed them, of course. Very importantly, economic policies have been generally sound.

On the financial front, the absence of significant exposures to the subprime market or to complex structured products in domestic financial systems has surely helped in this regard, but there are more structural reasons. In particular, there has been an important reduction of the financial vulnerabilities that were widespread in the past, and which led to costly crisis with important output losses and poverty increases, as the Asian crises ten years ago crudely demonstrated. Many emerging market economies have reduced their financing needs and improved their debt management. Many more run current account surpluses which reduce their reliance on external

funding. Most have accumulated massive international reserves, well in excess of what would be needed for precautionary reasons.

All in all, this paints a very different picture as compared to past episodes of global turbulence, when these economies used to be not only “influenced” by the ups and downs of the changing risk preferences in global financial markets, but simply “driven” –even “drowned”- by them, sometimes regardless of their economic fundamentals. In my view, this separation from the main stream of the turbulence constitutes an achievement in itself.

From other stand point, it is certainly striking that in this period of global financial turbulence inflation is identified as the key economic challenge for emerging economies. Indeed, the rise of inflationary pressures on food prices derived from the commodity boom, is becoming a very worrying concern. The large change in relative prices that underlies this prolonged boom is having a stronger impact on developing economies, with very negative and substantial effects on the well being of the poorest portions of their populations. Therefore, as inflation creeps up the concern of policymakers deepens, not only in the sphere of macroeconomic stability, but beyond. In connection with this, the fact that monetary policies have remained focused on inflation stability in most emerging market economies is an additional novelty to mention in the context of the present turmoil.

Going a step forward, it is also noteworthy that emerging market economies, and in particular Asia –with China at its centre- may become some kind of a “spare engine” to world growth, buffering the impact of the turbulence on global activity. This idea of a 'second pillar' for growth relies mainly on the observed strength of domestic demand in Asia, and the key issue here is whether this strength could be self-sustaining.

Maybe, we will not be able to answer this question thoroughly until the macroeconomic impact of the turbulence unfolds completely and the trade channel works itself out. But, one aspect that is clear -even now- is that some rebalancing from the current investment-led pattern to a more consumption-based model is required. This is not a simple task, since the underlying causes of the current growth pattern in some Asian countries -including China- are manifold. Issues such as the catching-up process, the need of a large part of the population to secure future incomes, or the role of the public sector in providing schooling and pensions, have all a role to play as has been widely discussed in recent years by scholars and policymakers in the region. In fact, the recently published Asian Development Outlook delves on some of these issues at great length.

As we will have the opportunity to discuss today, more developed financial systems can also greatly help to rebalance growth. Financial systems are instrumental in mobilizing savings and helping smooth consumption patterns. They are also key in transforming risk and allocating capital

to its more productive uses. Many of these functions are directly linked to some of the problems that Asian countries have been trying to solve over the past decade. To name but a few: very high saving ratios, possible investment overcapacity and slow take-off of private consumption. Although the investment-consumption patterns may already be changing in parts of Asia, there is still a large scope for improvement and more efficient and competitive financial systems can provide a fundamental support.

Ten years after the Asian crises, financial systems in the region have come a long way: asset quality has improved, profitability has been on the rise and so have capital ratios. Regulation and supervision have been upgraded as a result of the crisis. Financial depth is considerably higher in Asia than in Latin America and Eastern Europe, when measured by basic indicators such as the ratio of credit to the private sector as a share of GDP. Nevertheless, it is also true that credit is heavily biased towards the corporate sector in Asia. In the last years, consumer loans have been on the rise -along with home mortgage credit- in emerging market regions, such as Latin America or Eastern Europe; in Asia consumer loans have also taken off, and this is a positive development. But there are still issues and concerns about the real extent of changes in lending standards and the potential problems that rapid credit growth might pose if the global economy were to turn to a slower gear. Similarly, Asian banking systems remain relatively close to the participation of foreign banking, as compared to other emerging market regions, a development which may be foregoing important benefits in terms of modernization and competition.

All in all, I would conclude that the financial sector in Asia is still lagging behind when compared to other very dynamic and exemplary sectors in the region, such as certain industries, education and technology. I believe that this imbalance may eventually become a drag for the consolidation of a sustained growth path. Therefore, the development of the financial system is of central importance for the long-term growth perspectives. Under these circumstances, banking reform and restructuring is an important challenge that many Asian economies are inclined to face.

Let me tell you that in Spain we know well this challenge and its rewards. The highly successful performance of the Spanish economy over the past 20 years cannot be explained without taking into account the significant contribution by the financial sector and, in particular, by the banking system.

In turn, the transformation –and improvement- of our banking system in this period has been outstanding. This is evidenced, for example, by its favourable performance in terms of profitability, efficiency and solvency, both on an absolute basis and in comparison with other countries. Taking advantage of hindsight, I would like to stress two chief lessons learned from this twenty-year process of modernisation.

The first is that regulator and banks have formed a “joint partnership”, prompting a fruitful “virtuous cycle” and matching goals and efforts in order to attain efficiency and soundness. Close communication and constant exchanges of views are the principles currently governing this relationship.

The second lesson is that, at the end of the day, there has been no trade-off between profitability and soundness: the competitive capacity of Spanish banks has not been dented by supervisory policies. These policies have been oriented towards enhancing the solvency and internal governance of banks, and to increasing the confidence of the public and the markets in the banking sector.

However, this transformation has not been painless. It has to be recalled that the Spanish financial system had to overcome a deep-seated crisis in the mid-seventies to early eighties.

By the end of the 70s, our banking system was weak, closed, corporatist, old-fashioned and highly regulated. Such regulation affected many of their operating areas, curtailing competitiveness. Interest rates were set administratively and credit institutions were obliged to meet investment ratios to finance certain economic sectors with maximum interest rates. This environment made for weak structures with no incentive to compete and no professional teams or systems to accurately identify and manage risk. At that time a range of new banks were allowed to set up. Most of them were industry-oriented with special tax advantages, but with a fragile financial base and a lack of managerial integrity and experience.

Against that background, the system was highly inefficient and proved poorly effective because it was unable to develop its role of channelling saving to the most productive uses and, without any doubt, it held back economic growth. At the same time, the Spanish regulatory and supervisory framework was weak and outmoded, based mainly on a simple leverage ratio. In turn, supervision was geared towards formal compliance with administrative regulations.

The need for a change in the supervisory framework to preserve the soundness of the banking system became apparent when the oil crisis of the early 70s prompted the Spanish economy into a profound recession, leading to the deepest crisis of recent Spanish banking history. Up to 50 banks went bankrupt, involving 20% of the deposits of the banking system.

It is interesting to analyse the effect of the crisis and the limitations of the regulatory and supervisory framework at that time, in the light of the framework set by the Core Principles [for effective Banking Supervision] developed by the Basel Committee on Banking Supervision. Allow me to summarise the main group of principles that would have been breached.

First, the principles related to licensing criteria would not have been accurately met. Indeed, the process of licensing did not consist of a proper assessment of the fitness and propriety of Board members and senior management, including their strategic and operating plan. As mentioned before, a good number of banks were established, in the main with industrial interests, but on a fragile basis, and most of them became insolvent.

Second, banks did not follow prudent and appropriate policies to set in place a comprehensive risk management process to identify and control all risks with proper valuation standards. At that time the assessment of capital adequacy, as in many other countries, was based on a badly designed leverage ratio (capital on deposits) which was totally inappropriate in terms of the risk profile of the banks.

Third, the supervisory system was not equipped with appropriate human, technical and organisational tools to ensure a thorough understanding of the operations both of individual banks and banking groups and to monitor them. Additionally, the supervisor did not have corrective and remedial powers to apply timely and efficient surgical measures.

Ensuing this episode, the Spanish authorities embarked on a thoroughgoing process of liberalisation, modernisation, de-regulation, re-regulation and promotion of competition. Although there was much ground to be covered, Spain comprehensively reformed the regulatory and supervisory framework in a relatively short period, during the 80s. Supervisory powers and the more detailed banking regulations were placed within the remit of the Banco de España.

Among the wide array of measures taken I would like to highlight the following:

- **Interest rates and fees for banking operations were fully liberalised** and the compulsory investment ratios were gradually lifted.
- **New capital regulations** based on the Basel I model were implemented. In the new regulation there was a more appropriate relationship between loans granted (risks) and capital, instead of deposits and capital.
- Banco de España was empowered to issue **accounting regulations** for banks. It duly laid down new prudent accounting rules, in particular regarding loan classification and loan loss provisioning. Since then, the authority to establish accounting standards for banks has proven to be one of the most powerful tools at our disposal.
- **Supervisory reporting** was established. This is an essential element of supervision which allows for proper monitoring of the situation of banks.

- The **Central Credit Register** was introduced in the sixties, with all credit institutions required to report regularly to it. This database is exploited for supervisory purposes and will play an important role in Basel II supervision. It can also be used by the banks for credit risk management purposes.
- Since the seventies Spanish banking supervision has paid particular attention to obtaining **"first-hand" on-site assessments** of developments, to complement its continuous and close monitoring of every institution.
- The growth of the financial markets called for more transparency and better regulation of **external auditing**. A new law was passed making the external audit of the annual accounts compulsory for every company above a certain size, and for all financial institutions regardless of their size.
- In the area of **crisis prevention and resolution**, the crisis in the early eighties revealed the lack of sanctioning powers and tools for crisis management. The list of possible infringements was updated. The supervisory authority was also given new tools for crisis management -as intervention measures or the replacement of management-, and an ex-ante Deposit Guarantee Scheme was established, which is also prepared to offer help and bail-out plans.

This set of measures promoted and encouraged banks to adopt appropriate risk control systems and practices oriented towards prudent performance and enhancing transparency with both clients and markets.

Beyond these changes, Spanish banks also learned direct lessons from the banking crisis, and managed to cope with the challenges linked to competing in a liberalised environment. In fact, banks realised that they have to make continuous efforts to retain adequate internal risk control methods and to invest in technology and human capital. Furthermore, banks have to maintain their capacity to adapt to a changing environment and be able to take advantage of the new financial landscape.

The supervisory model will face new challenges ahead, as the global banking system is continuously evolving. New products of increasing complexity and new players subject to little or no regulation are continuously appearing. The model must be flexible enough to maintain its adaptability, without losing its solid foundations. Accordingly, Spanish banking supervision has recently developed its own methodology based on the continuous monitoring of every banking institution, complemented by frequent on-site inspections. This methodology incorporates a risk-focused approach, that enables it to strengthen preventive measures without forsaking the objectives of solvency and stability.

There are no doubts that in the current context of deceleration in the world economy, distortions and tensions in global financial markets and an increasingly uncertain economic outlook, to have a sound and securely managed banking system is of paramount importance. Only on that premises will we be firmly placed to meet the fresh challenges arising from the new financial environment.

And, in this context, the Spanish experience provides us with final lesson: that any process of financial liberalisation or rapid innovation has to be accompanied by the application of appropriate regulatory and supervisory measures.

Thank you for your attention