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Financial stability and price stability in times of uncertainty*

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* English translation from the original in Spanish

Director, other eminencies, ladies and gentlemen, good morning. I am honoured to participate in this Forum organised by El Norte de Castilla, which I believe follows in the best traditions established by Miguel Delibes when he was Editor of this newspaper. First, I would like to thank Goyo Ezama, the general manager of El Norte de Castilla, for giving me the opportunity to offer some reflections that I trust will be of interest.

The initial part of my address will be devoted to the episode of financial turbulence that we have witnessed in recent weeks. Afterwards I will explain the decisions taken by the ECB's Governing Council at its latest meeting on 16 March 2023. Lastly, I will describe the economic outlook for Spain and the euro area.

The current episode of financial turbulence

In recent weeks, the deterioration in the financial position of certain medium-sized banks in the United States, which led to the resolution of Silicon Valley Bank (SVB) and to the take-over of the Swiss bank Credit Suisse by UBS Warburg, with the support of the Swiss government, has driven up investor risk aversion and financial market volatility and led to a global drop in bank share prices.

In order to assess the implications of these events for the European banking system and, in particular, the Spanish banking system, it should be noted that certain idiosyncratic factors have contributed to the financial problems of these banks.

In the case of SVB, its loans and deposits were highly concentrated among venture capital, Fin Tech and start-up firms, and it was heavily dependent on funding in the form of wholesale deposits, the vast majority of which were not protected by deposit insurance. Also, most of its assets consisted of debt securities, which fall in value when interest rates rise. The sudden withdrawal of deposits obliged SVB to liquidate its debt securities at a loss, which led in turn to further deposit withdrawals, generating a rapid decline in solvency and liquidity. It should be noted here that: (i) US banking regulations exempt medium-sized banks, such as SVB, from certain prudential requirements for liquidity (the liquidity coverage ratio (LCR) and the net stable financing ratio (NSFR)) and capital, (ii) stress tests are conducted less frequently for such banks than for larger ones, and (iii) they are permitted to choose not to reflect in their regulatory capital any unrealised losses on the available-for-sale securities on their balance sheets.

In the case of Credit Suisse, a global systemically important bank, the loss of investor confidence was closely related to the losses on its investment banking business, the failure of high-risk investment strategies in the past (e.g. Archegos and Greensill) and the materialisation of operational risks that did significant damage to perceptions of its reliability, a key factor in banking. As a matter of fact, this bank was engaged in the complex process of transforming its business model and had suffered significant liquidity withdrawals in the final quarter of 2022.

These idiosyncratic factors are not relevant in the case of European and Spanish banks and, therefore, the experience of these banks should not automatically be applied to the Spanish banking system.

First, the euro area banking system, including, of course, the Spanish system, is facing these market tensions from a highly resilient position and with sound capital and liquidity positions. This has been the result of regulatory reform agreed internationally over the last decade. In Europe, these reforms have been applied to all banks, irrespective of their size. All Spanish banks are therefore subject to the same strict capital and liquidity requirements.

Indeed, despite the unprecedented adverse shocks they have suffered over the last three years, Spanish banks have actually improved their solvency levels and further reduced their non-performing loan ratios in this period. Also, the stress tests conducted within the Single Supervisory Mechanism and by the national macroprudential authorities, including the Banco de España, testify to elevated aggregate resilience to various severely adverse hypothetical scenarios.

Second, Spanish banks' gearing towards the retail segment has recently contributed to positive profitability developments, in a context of rising interest rates, and to a favourable liquidity position and good financing conditions.

Thus, Spanish banks' profitability has grown significantly over the past year, to above the cost of capital, benefiting from the positive effect of higher interest rates on banks' net interest income and the increase in fees and commissions. In fact, under the baseline scenario of the latest macroprudential stress test exercises conducted by the Banco de España and described in our last Financial Stability Report,¹ bank solvency ratios increased on average over the projection horizon. This scenario was compatible with the latest macroeconomic projections at the time and incorporated a significant increase in interest rates, in accordance with market expectations.

Spanish banks have high liquidity ratios, both in the short term and in terms of stable funding over a longer period, standing at the higher end of the distribution of these metrics among their European peers. The retail orientation of Spanish banks' business, in clear contrast to SVB, for example, also contributes to this sound liquidity position and to the stability and diversification of funding sources.

Third, with regard to solvency, an important factor in the case of SVB is the share of financial instrument holdings, in particular of debt instruments, and how they are valued for the purpose of calculating capital. The share of these portfolios in the balance sheets of Spanish banks is similar to that for other European banks and much lower than in the case of SVB. In addition, as in the case of other European and international banks, a portion of the debt securities held by Spanish banks is classified as held-for-sale. In accordance with the regulatory treatment of such portfolios in the EU, this portion is measured at market prices. Any potential gains or losses have therefore already been recognised against the banks' capital. This is a very important distinction from medium-sized US banks.

Another portion of the fixed-income portfolios of European and Spanish banks is intended to be held to maturity. These debt securities are therefore classified and recognised as such. Banks deem these portfolios to be a balance sheet risk management tool, to make their

¹ See Box 2.2 of the Banco de España's autumn 2022 Financial Stability Report: "Forward-looking assessment of the Spanish banking system's resilience" (https://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/InformesEstabilidadFinancera/22/FSR_2022_2_Box2_2.pdf).

balance sheets less volatile and, above all, less procyclical. Held-to-maturity portfolios are accounted for at amortised cost, not at their market value. Only if banks were to sell these portfolios before maturity would the potential unrealised losses materialise, specifically at the moment of sale. Given banks' high liquidity ratios and their improved earnings in 2022, this circumstance is unlikely.

Fourth, the role of banking supervision should also be stressed. Even before recent events, certain supervisory priorities had been set within the Single Supervisory Mechanism specifically to mitigate and anticipate the adverse effects of the current macroeconomic context. In particular, the supervisory focus was placed on banks' interest rate risk and the sustainability of their funding plans, issues that are crucial in a context of rising interest rates and liquidity withdrawal by central banks. And the most exposed European banks were required to improve the way in which they monitor and manage this risk. In some cases they were even asked to be more conservative in their interest rate assumptions and in their model calibration and validation.

Similarly, when it emerged that there were interconnections between the banking system and non-bank financial intermediaries, as in the case of Archegos, which as I have already said particularly affected Credit Suisse, the decision was also made to place the supervisory focus on analysing the risks for European banks of this type of exposure.

Fifth, the swift, forceful decisions taken by the US and Swiss authorities have clearly been essential to ensure financial stability and re-establish appropriate market conditions. However, in comparison with Switzerland, it should also be noted that, as a result of the reforms approved in the wake of the global financial crisis by the Basel Committee on Banking Supervision, which I chair, and by the Financial Stability Board, we have a resolution framework in the European Union that has already been applied consistently on a number of occasions. This framework clearly establishes the order in which a distressed banks' shareholders and creditors must absorb any losses. First in line are CET1 capital instruments, which include the bank's shareholders and reserves. Only if these are exhausted would AT1 instruments be used.

In any event, beyond the foregoing considerations and as I have noted on several occasions over the past year, in a macro-financial situation in which interest rates have had to be raised swiftly to contain inflationary pressures, banks face risks to their net interest income, the value of their holdings of financial instruments and their balance sheet credit quality. Banks whose average lending rates have adapted faster to the new situation than their average deposit rates (e.g. those with a greater share of variable rate loans and/or shorter maturities, and a greater share of retail funding) are seeing a substantial improvement in their net interest income, which has boosted their profitability. Conversely, the value of fixed-income financial exposures (e.g. bonds, especially those with longer maturities) has declined. Additional upward adjustments to banks' cost of financing and, over the medium term, some deterioration of credit risk quality will be more likely the longer the high-interest rate period continues. The extent to which different banks and financial systems position themselves against these risks, which has now attracted more attention from investors, will determine how resilient they are.

In an environment as uncertain as the one we have been experiencing in recent months, including in relation to the degree of future monetary policy tightening, our banks must implement a prudent provisioning and capital planning policy, using part of the current short-term increase in income to further raise the sector's resilience. This would leave banks better placed to deal with any losses should the different risk scenarios currently identified materialise.

In addition, allow me to reiterate the Banco de España's position on the need to continue improving the governance and functioning of the Economic and Monetary Union. We have long defended the need to complete the banking union through the creation of a fully mutualised European deposit guarantee fund. The commitment to deploy such a scheme would have a strong impact on the confidence of citizens and the markets and would contribute to increased risk-sharing in the euro area and, thus, to reducing potential episodes of fragmentation. Also, it would help to align financial responsibility with the banking supervision and resolution decision-making mechanisms, which are already centralised.

Lastly, allow me to stress the need to analyse in depth the recent developments from a regulatory and supervisory perspective. The US Federal Reserve System has already announced a review of the reasons for what has happened to be released by the 1st of May. In the Basel Committee on Banking Supervision meeting held last week in Hong-Kong, we also decided to conduct an analysis of recent developments, so that we can draw lessons.² It is these exercises that allow us to refine regulations to ensure they are adapted to the diverse circumstances that may arise in practice.

The ECB's monetary policy decisions in March

I will now explain the latest monetary policy decisions of the ECB Governing Council.

The main message of the ECB Governing Council meeting held on 16 March is that, in the setting of financial tensions described previously, which we are closely monitoring, we stand ready to respond as and when necessary to maintain price stability and financial stability in the euro area. In particular, we will, if necessary, provide sufficient liquidity support to the financial system in the euro area and will counter any threat to the transmission of monetary policy. We need to remember, as we underlined in our monetary policy strategy review published in July 2021, that financial stability is a prerequisite for price stability.³

At the March meeting, we decided to raise the three key interest rates by 50 bp, taking the deposit facility rate to 3%. This decision gives continuity to the monetary policy tightening path we initiated in December 2021, which up to now has translated into a cumulative rise of 350 bp in the key interest rates since July 2022. This was in line with what was anticipated in the February meeting and was underpinned by our assessment of the inflation outlook in the euro area, which points to inflation remaining too high for too long. The assessment was based on a new ECB staff macroeconomic projections exercise, which I will describe later on.

² See <https://www.bis.org/press/p230323a.htm>

³ See https://www.ecb.europa.eu/home/search/review/html/ecb.strategyreview_monpol_strategy_overview.en.html

The ECB projections exercise was finalised a few days before the recent emergence of financial turmoil and the ECB's Governing Council was fully aware that these tensions imply additional uncertainty around the baseline economic and inflation assessments. This extra uncertainty made the data-dependent approach for our decisions even more important. In a context with so much uncertainty, the most sensible thing is to underscore that our future monetary policy decisions will depend on how the different sources of risks, including those witnessed on the financial markets in the last few days, materialise.

Future interest rate movements will be determined by our assessment of the inflation outlook, which will itself depend on three factors. First, incoming economic and financial data. Second, the dynamics of underlying inflation. And, lastly, the strength of monetary policy transmission. The financial market stress of recent days could directly impact the latter, by further tightening financial conditions and affecting the economic and inflation outlook in a downward direction. These developments should be taken into consideration at our next meetings.

The economic and inflation outlook in the euro area and in Spain

As I noted earlier, the monetary policy decisions taken at our March meeting were based on an assessment of the inflation outlook for the euro area which was underpinned by the new ECB staff macroeconomic projections.⁴

The new forecasting exercise points to a weakening of activity. Specifically, real GDP in the euro area is expected to grow by 1% in 2023 (after 3.6% in 2022). This scenario is somewhat more optimistic than that of the previous Eurosystem projections (published in December), reflecting better-than-expected recent economic data and the fall in the cost of energy, so that economic agents' real income losses are lower.

Growth is expected to pick up, to 1.6%, in both 2024 and 2025, based on a robust labour market, improving confidence and the recovery of purchasing power. However, this less buoyancy is less than projected in December owing to the tightening of financial conditions, including a stronger euro exchange rate.

After peaking at 10.6% in October, inflation declined to 8.5% in February, on the back of lower energy prices and base effects (which include the automatic fall in the year-on-year growth rate of prices following the sharp increases in 2022). By contrast, food price inflation and underlying inflation (excluding energy and food) have continued to rise, surprising on the upside and posting high rates in February (15% and 5.6%, respectively).

Headline inflation is expected to remain high for the rest of 2023, albeit on a downward trend that will take it to 2.8% in the last quarter of the year. This drop in inflation is mainly explained by the energy component, while underlying inflation is expected to remain high.

Nonetheless, these pressures on the rate of underlying inflation are expected to ease progressively, with inflation returning towards the 2% medium-term target. Specifically, the ECB projections exercise points to inflation averaging 5.3% in 2023, before decreasing to

⁴ [ECB macroeconomic projections of 16 March 2023](#).

2.9% in 2024 and 2.1% in 2025. This downward trend would be underpinned by the gradual disappearance of upward pressures from the reopening of the economy and previous supply shocks (namely supply bottlenecks and high energy prices), and by an easing of demand, which will increasingly be contained by monetary policy tightening.

These projections are subject to various sources of uncertainty, including, naturally, those relating to the recent financial tensions.

The balance of risks to the euro area growth outlook is tilted to the downside by the war in Ukraine – which might push energy and food commodity prices back up – and a more abrupt global economic slowdown than anticipated. These are compounded by the financial tensions, which, should they persist, could lead to a sharper-than-expected tightening of credit conditions and erode confidence.

On the inflation front, the upside risks notably include the enduring presence of latent pressures, which could see consumer price growth outstrip expectations in the near term. Over the medium term, the risks stem primarily from a persistent rise in inflation expectations above our target level or more robust growth in wages and profit margins than anticipated. Likewise, a stronger-than-expected economic recovery in China could give renewed impetus to commodity prices and external demand. Conversely, the deflationary process might be hastened if (i) the heightened financial market tensions prove enduring, (ii) the decline in energy prices passes through more intensely than expected or (iii) the weakening of demand is exacerbated by the slowdown in bank lending or a more effective transmission of monetary policy.

Allow me to end by briefly describing the current outlook for the Spanish economy.

The factors that are influencing economic activity and inflation are, in the main, global. Accordingly, the Spanish economy faces a scenario much the same as I have described for the euro area. Indeed, the Banco de España's latest macroeconomic projections – published last week⁵ and, like the ECB projections for the euro area, prepared before the current episode of financial tensions – envisage a situation very similar to that for the euro area as a whole.

In 2023, GDP growth in Spain is expected to slow substantially with respect to 2022, reaching an annual average rate of 1.6% (down from 5.5% last year). This forecast for 2023 entails an upward revision compared with the December projection, as a result of an upturn in activity in the second half of 2022 and an improved external and domestic outlook for this year. Indeed, the Spanish economy appears to have been slightly more buoyant in the first quarter of 2023 than in the second half of 2022.

Output growth is expected to gather pace in the second half of the year, putting the annual average growth rate for 2024 at 2.3%, before easing to 2.1% in 2025. That growth is stronger than projected for other European countries, and could be underpinned by a stronger performance from the sectors hardest hit by the sequence of shocks witnessed in recent years. Likewise, the use of NGEU funds should provide significant support for economic activity. Nevertheless, the growth forecast for 2024 represents a downward

⁵ [Macroeconomic projections for the Spanish economy \(2023-2025\). March 2023. Banco de España.](#)

revision of 0.4 pp, due to expectations that financing conditions will tighten further and the assumption of a somewhat larger fiscal adjustment.

As for inflation, the headline figure eased to 6.0% in February, down from its peak of 10.7% in July 2022. The decline in inflation was almost exclusively attributable to the energy component, which is now recording negative year-on-year rates. Conversely, in recent months underlying inflation has mainly surprised to the upside, reaching an all-time high of 5.2% in February. At the same time, food prices have continued to accelerate – and likewise more sharply than expected – driven in particular by the inflationary pressures surrounding processed food.

In average annual terms, headline inflation is expected to decline significantly from 8.3% in 2022 to 3.7% in 2023. However, it is assumed that the measures deployed by authorities to mitigate the effects of the energy crisis will expire at end-2023, which would hinder any further reductions in 2024. As a result, in that year the inflation rate is expected to hold at 3.6%, before easing to 1.8% in 2025.

In 2023 the decline in inflation will remain driven by the energy component – based on the energy price expectations signalled by futures markets – and by significant negative base effects linked to the energy price developments in 2022. Conversely, underlying and food inflation are expected to show greater downward stickiness, given that past increases in energy costs are passing through to the final prices of consumer goods and services with something of a lag. However, both underlying and food inflation should also begin to decline to the extent that (i) the pass-through of past cost increases nears completion, (ii) the recent energy cost declines also begin to pass through, (iii) the bottlenecks clear and (iv) the impact of the cumulative monetary policy tightening materialises. In any event, in 2024 that decline would only be enough to offset the energy component's larger positive contribution to price growth (due to expiry of the measures deployed to contend with the energy crisis), seeing headline inflation stand at very similar levels to the average for 2023, before easing again in 2025.

Against this background of persistently high inflation, allow me to again stress the importance of reaching an incomes agreement in Spain to stave off an inflationary spiral. As I have said on a number of occasions, the source of high inflation in the euro area and, naturally, in Spain was the surge in the prices of the energy inputs we need in order to produce and consume, but which we lack and thus have to import. We are currently facing what economists call a deterioration in the terms of trade, which entails a loss of wealth and welfare for the Spanish economy as a whole. And this loss is inevitable in the short and medium term. The only thing we can do is allocate it among the different economic agents. The aim of the national income pact is none other than for workers and employers to share this loss fairly. Doing so would also prevent the inflationary spiral that would arise were they both to attempt to unilaterally avoid this loss by maintaining their real wages and profit margins. Logically, this cannot be done at the macroeconomic level.

Lastly, as in the euro area, uncertainty is at very high levels, and more so following the recent episode of financial tensions, whose effects are not factored into either the ECB's projections for the euro area or the Banco de España's forecasts for the Spanish economy.

Should they persist, those tensions could give rise to a scenario of more moderate economic growth and more rapidly declining inflation.

Concluding remarks

In sum, the recent financial stresses triggered by the deteriorating financial position of Silicon Valley Bank (STB) and Credit Suisse have prompted further turbulence, forcing us to contend with exceptionally high levels of uncertainty. Against this background, our future monetary policy decisions should be informed by prudence and follow a data-dependent approach.

The euro area banking sector, and within it the Spanish banking system, is well prepared for severe adverse scenarios thanks to its considerable resilience and sound capital and liquidity position. This owes in no small measure to the regulatory reforms agreed internationally over the last decade, which have been applied to all banks in Europe, irrespective of their size.

That said, this episode throws into sharper relief the need for our banks to implement prudent provisioning and capital policies, whereby a portion of the current short-term increase in profits can be used to further bolster the sector's resilience. This would leave banks better placed to absorb any losses should the different risk scenarios identified materialise. It also underscores the need to complete the banking union – with the implementation of a fully mutualised European Deposit Guarantee Scheme – and to diligently assess and learn from the recent course of events to further improve our supervision and regulation. The Basel Committee on Banking Supervision will conduct such analysis over the coming months.

Allow me to end by recalling that we on the ECB Governing Council are monitoring these financial developments closely. Should greater risks to the banking sector materialise than might be anticipated at present, the ECB and the national authorities stand ready to act as and when necessary to safeguard the financial stability of the euro area, as a prerequisite for ensuring our price stability target.