

TESTIMONY OF THE GOVERNOR OF THE BANCO DE ESPAÑA, MIGUEL FERNÁNDEZ  
ORDÓÑEZ, TO THE PARLIAMENTARY COMMITTEE ON ECONOMIC AND FINANCIAL  
AFFAIRS

**Testimony of the Governor of the Banco de España, Miguel Fernández Ordóñez,  
to the Parliamentary Committee on Economic and Financial Affairs**

I have been asked to appear before Parliament to inform you of the Banco de España's management of the Fund for the Acquisition of Financial Assets and share with you its analysis of the current situation of credit flows.

As you know, the Fund for the Acquisition of Financial Assets is assigned to the Ministry of Economic Affairs and Finance, which by law is responsible for administering, managing and directing it through an Executive Council and its Executive Committee. Yesterday's testimony by the State Secretary for Economic Affairs to this Committee gave a comprehensive account of the management of the Fund. The Banco de España's function is to carry out its financial asset selection and acquisition operations and to act as the custodian bank of its portfolio. Every two months the Banco de España reports in detail to the Executive Committee on the execution of the Fund's transactions. The first of these regular reports was submitted by the Banco de España to the Executive Committee of the Fund, and you are familiar with it.

As described in that report, to date four auctions have been held in which a total of nearly €20 billion was allotted. The Fund implementation work consists of entering into and settling transactions which are carried out through the purchase, on a temporary or held-to-maturity basis, of the financial assets which thereby become part of the Fund's assets. Maintenance tasks on the portfolios of securities acquired are also carried out.

We are all aware that this testimony comes at a particularly delicate time, not only for the Spanish economy, but also for that of the world. We would have to go back at least 80 years to find a situation of global risk comparable to this one. In these conditions, we have to avoid a simplistic approach focused on facets taken in isolation from reality and from the complex environment in which they are set.

You will therefore understand why I devote my testimony not only to describing and analysing the information available at this time, but also to setting it appropriately in the context of the current developments in the international financial and credit markets and in the Spanish economy.

Allow me, then, to begin by reviewing the most recent data available to the Banco de España in its dual capacity as credit institution supervisor and as producer of monetary and financial statistics. We make these statistics available to the community regularly in our publications and on our website. As you undoubtedly realise, however, the collection and processing of the input information used to compile the statistics takes time and, at this moment, the most up-to-date data available relate to January, although it should be noted that they are largely provisional.

Ministry of Economic Affairs and Finance Order 3118/2008, which implements Royal Decree-Law 6/2008, recently entrusted the Banco de España with "a four-monthly analysis of the general financial conditions in which the Fund for the Acquisition of Financial Assets conducts its activity and of developments in bank lending" to be submitted to the government, which, in turn, will send it to Parliament within the framework of the scheduled parliamentary control of this Fund's activities. Once this has taken place, we will have full information on the first quarter of this year.

Hence, taking January as the reference month, Spanish household and corporate credit are, on the available information, growing at a year-on-year rate of nearly 6% (5.8%). In net terms, i.e. subtracting the effect of past loan repayments, this sector received approximately €110 billion of financing in the past 12 months.

A breakdown of these figures by market segment shows differences of some size between firms and households. House purchase loans to households were growing at a rate of nearly 4% (4.2%), which was faster than that of loans for consumer and other purposes (3%).

Funds granted to firms, however, showed greater dynamism, with rates of around 6% (6.1%). This rate, however, masks significant differences between different productive sectors. It should be noted that the information allowing this sectoral breakdown becomes available with a certain lag, but there are no signs that there will be a break in the existing trends, which have been showing a much sharper slowdown in financing to construction firms and those engaging in real estate development services and a smaller loss of momentum in financing to industry and to other services firms.

It is highly likely, in any event, that part of this corporate credit growth reflects not so much the most recent lending decisions of banks as a much more intensive use by non-financial corporations of credit lines opened in the past under less demanding conditions than those currently prevailing, which allow institutions little or no leeway to take action.

Along these same lines, I wish to point out that the dynamism reflected by year-on-year growth rates diminishes notably when a time horizon shorter than one year is considered. Hence, looking at only the last three months from November 2008 to January of this year, the growth rate of credit to other resident sectors, expressed in year-on-year terms for comparison purposes, drops to values a little above 2% (2.1%). This is equivalent to an increase of €10 billion in the outstanding balance of the total credit granted by institutions resident in Spain in the fourth quarter of 2008, or, in annual terms, somewhat more than €40 billion.

To put this lending behaviour in Spain into context, it is useful, as an initial point of reference, to compare it with bank lending in other major developed countries, although taking care to keep in mind that in some of them (specifically, the United States) credit institutions play a much less active role in the provision of financing to firms, which raise funds directly on the market to a much greater extent than in Spain.

Allow me, for the sake of brevity, to spare you the detail of the figures and simply to say that what that comparison shows is that the loss of dynamism in credit is shared by most economies, including most notably the euro area, United Kingdom and United States. In Spain, the slowdown has been more marked because it started from higher levels, but the process here has not so far reached the seriousness it has in those other economies.

Another key point of reference is how credit behaved in other economic slumps. From this standpoint, the adjustment of credit should not surprise us, since it is a variable with a marked cyclical behaviour: when the economy grows, bank lending tends to do so at a comparatively faster rate, so the debt ratios of the private sector increase. By contrast, cyclical downturns are accompanied by a rapid contraction of credit growth, which tends to stand below that of GDP, and the relative debt of households and firms decreases.

The behaviour of Spanish credit and GDP fits exactly the pattern I have just described. In the last recession in Spain, at the end of 1993, bank lending contracted year-on-year by some-

what more than two percentage points (2.2%), a short time after nominal GDP growth reached a minimum only slightly above zero. And that was in the absence of financial strains comparable to those seen at present.

In just one month, we will make public our growth projections for the Spanish economy, continuing the practice commenced two years ago. As you will undoubtedly understand, I am unable to give specific figures. Nonetheless, the still largely unrevised figures clearly point to a recession of some depth, as do the projections being issued by other organisations, such as the International Monetary Fund, the European Commission and the OECD.

The Spanish economy is unquestionably passing through a period of contraction with low inflation, which will make for an extremely modest, if not negative, growth rate. As seen in the past, a situation like this would, by itself, be expected to lead to very weak or even negative credit expansion.

It is now necessary to superimpose on this scenario the further contractionary affects on lending derived, on one hand, from the severity of the crisis of confidence accompanying the current recession and, on the other, from the marked financial stress inevitably accompanying the serious events at worldwide level, with major bank failures which required voluminous and exceptional rescue plans in the countries affected.

I thus wish to begin my assessment of the credit situation in Spain by looking, first, at the reasons why the strong contraction of the Spanish economy inevitably affects lending. I leave for later a consideration of the more direct effects of the crisis in the international financial markets.

As in the case of so many other goods and services, the observed credit behaviour results from different forces operating both on the demand side and on the supply side and which, in this case, are tightly synchronised with the business cycle.

Economic downturns are characterised, first, by a widespread decline in household and corporate spending, which naturally means that less funds are needed to finance that spending. Also, firms' and workers' expectations about their future income and, in the case of the latter, about their employment prospects, are usually revised downwards in recessions, especially if the recession resulted from a need to correct the imbalances accumulated during the expansionary phase of the cycle. Obviously this revision of their future ability to pay naturally also has a contractionary affect on the demand for credit.

From early 2003 the Banco de España, in coordination with the other Eurosystem central banks, has been carrying out a regular quarterly survey of credit institutions to improve our knowledge of the euro area credit markets: the bank lending survey. It is one of the few tools which allows us to separate the components of demand and supply underlying observed credit behaviour. The bank lending survey clearly shows that private-sector demand for credit has been declining in Spain since late 2006. This is before the international credit crisis broke out and more in line with the first incipient signs of an adjustment to the Spanish economy, the pace of which was subsequently accelerated by that same crisis.

The fall-off in demand, however, is insufficient to explain alone the strong slowdown in lending. The cyclical position of the economy also plays a central role in the behaviour of the supply of financing. When GDP growth turns negative and unemployment increases, households and firms find it more difficult to keep up their debt repayments. This means that funds which, in

other circumstances, could have added to the flow of credit, have to be set aside by credit institutions to cover growing bad debts. This increase in bad debts is evident in Spain, although it started from fairly low levels and Spanish banks have a significant cushion of provisions to enable them to cope with this increase in defaults.

From a more medium-term standpoint, the same phenomenon of downward revision of expectations as to the economy's future dynamism which adversely affects credit demand also puts pressure on institutions which, faced with the change of cycle, will tend to correct upwards their assessment of the risks associated with their operations and therefore tighten their conditions for new lending.

Institutions' responses to the bank lending survey confirm that these supply effects are having a major impact on the recent behaviour of credit in Spain. More specifically, the bank lending survey shows that the tightening which is taking place is basically due to a revision of bank expectations about economic growth in general, about the future of specific markets of great importance for credit, such as housing, and about the solvency of consumers.

Other factors, such as difficulties in funding loans or the potential constraints associated with the desired levels of capitalisation, which are more directly linked to the crisis currently besetting the international financial markets, play a less significant role. However, their influence may be beginning to increase and they may take their place alongside the traditional cyclical determinants of credit supply.

In past testimonies I have described in detail how, for various reasons, this international financial crisis found Spanish credit institutions in a position of relative strength, which enabled them to withstand the initial onslaught relatively unscathed. However, the prolongation of those tensions and, above all, the negative feedback between the financial and real sectors to which they have given rise, have generated indirect or induced second-round effects. Averting some of these indirect effects will be complicated.

Among those which should not be cause for great concern are the effects linked to the persistence of a problem of lack of liquidity in the money markets. When liquidity strains become chronic, this increases the danger that they will ultimately degenerate into insolvency. However, this risk has been substantially covered by the action taken by the Eurosystem, which has substantially enlarged the volume of liquidity it provides to institutions, and has extended, also amply, the range of securities it accepts as collateral in those loans. The Eurosystem's manifest readiness to pursue this policy as long as the tensions last strengthens my conviction that this type of risk will no longer constitute a determining constraint.

However, apart from liquidity problems, the evident excesses committed in many countries during a long period of markedly lax financial conditions are now forcing widespread deleverage among financial intermediaries, which are now finding that their capital levels are limiting their ability to grant loans. The information available at this time does not yet indicate that in Spain this affect is significant, but it is obviously a source of risk to be taken into account.

Also, the ongoing state of collapse of the international wholesale markets in which Spanish institutions had been borrowing most of the funds needed to finance excess domestic spending poses significant challenges for the Spanish financial system. The temporary solutions undertaken in the face of the first wave of direct effects of the crisis – and I naturally refer to the recourse to the Eurosystem and to the issuance of commercial paper – are useful, but limited in scope. As in the case of deleverage, our analyses do not reveal that the funding difficulties are

playing a determining role at this time, but do suggest that their influence on institutions' credit policies is increasing.

Last but not least, the beginning of a recession, particularly one set against a backdrop of financial crisis, is a phase prone to the overreaction so common in financial markets. The tendency to overreact may lead institutions to exaggerate the risks of borrowers and, consequently, give rise to an excessive contraction of the credit supplied by them.

All these risks of credit restriction resulting from the need for deleverage, from the insufficient funds available on wholesale markets and from the tendency to overreact are not by any means exclusive to Spanish institutions. On the contrary, some of them have already materialised, with clearly severe effects, for certain institutions in other countries. In response to them, exceptional measures have been adopted in various countries and headway has been made in the design of common concerted guidelines in some areas, such as the European Union. The variety of experience gained from these interventions allows an inventory of the tools used to be compiled. This gives a better idea of those available and of their potential efficacy in correcting the adverse lending conditions.

The first set of measures aims to stop the lack of confidence from spreading through the banking system. These mutual misgivings arose as a result of the stress to which certain specific banks, none of them Spanish, were subject at the onset of the crisis. In view of the imminent danger of a bank panic, which could have brought the simultaneous collapse of the financial system in various countries, the coverage provided by deposit guarantee funds was extended and, more generally, the authorities undertook not to allow possible bankruptcies to harm depositors. I do not believe I am being over-optimistic when I affirm that this objective was fully achieved.

Action was also taken to ensure the availability of liquidity at maturities exceeding those currently envisaged in monetary policy operations, even after the increase in the amounts and maturities of the customary Eurosystem auctions. The creation in Spain of the Fund for the Acquisition of Financial Assets is a good example of the type of specific instruments designed in this regard to provide liquidity at longer time horizons.

The countries most affected by the crisis have also taken measures to prevent the process of credit institution deleverage from adversely affecting their ability to finance spending projects, through the recapitalisation of banks with government funds and the introduction of programmes to purchase impaired bank assets. As you know, none of these actions has been necessary in Spain, although the royal decree-law of last October established the legal basis to carry out recapitalisation operations, if and when necessary. In view of the enormous uncertainty as to the outcome of this international financial crisis, it would not seem prudent to rule out the possible use of measures of this type at some later time in the process.

As is well-known, Spanish institutions' balance sheets are free from so-called "toxic" assets. This has been a key factor in their resilience to the initial onslaught of the crisis and represents a major difference from what is happening in the national financial systems most severely affected by the crisis. However, this does not mean that Spain's financial system will be immune to the processes which the financial crisis has unleashed.

In any event, if the depth of the financial crisis and the accompanying deterioration of the macroeconomic environment do finally bring a reorganisation of the Spanish financial system, we must not overlook another singular strength of Spain's institutional framework. Unlike other

countries, Spain has deposit guarantee funds which are financed by contributions from the sector itself and, if necessary, can play an important role in possible operations to restructure a given institution. They have proved to be very effective in situations of this type in the past, and have thus built up experience and a reputation which may be very useful.

Nearly 20 months have passed since the international financial crisis broke out. During this time the Spanish banking system has demonstrated its soundness and solvency. But this does not mean that it is immune to the most serious worldwide economic and financial crisis of recent times. As remarked earlier, the depth of the crisis may require a restructuring of our banking system. If so, the Banco de España will act as it always has: with the aim that neither depositors nor creditors are affected at all. And, naturally, with discretion and professionalism.

Returning now to the range of measures taken, particular mention should be made of those designed to address the funding difficulties in international wholesale markets through the provision of government guarantees for the bond issues of institutions which meet certain requirements. The European Commission has designed a common framework for the provision of these guarantees in Europe, in order to reduce to a minimum possible harmful effects on competition and equal treatment. In numerous countries, including Spain, institutions are already making use of these facilities and, although their introduction is not free from complications, market funding is again becoming possible, which means that one of the most serious factors of blockage is being overcome. Nonetheless, the funding available continues to be scant and expensive, since savers are still providing funds very cautiously and only in exchange for high remuneration.

This brief review would not be complete without mentioning another set of important measures aimed at mitigating the effects that the tighter credit conditions may have on specific sectors or agents that are highly vulnerable to market strains of this type. This type of action includes, for example, diverse measures to help small and medium-sized enterprises gain access to funds or to enable households in particular difficulty to renegotiate the terms and conditions of their loans. Along these lines, financing programmes to provide substantial amounts to these sectors have been undertaken through the Instituto de Crédito Oficial (Official Credit Institute) in Spain.

The range of measures available is thus extensive. The challenges and complications are so formidable that the most severely affected countries are still striving to find suitable mechanisms and not a day passes without some new proposal being put forward. However none of these measures is free from risk, and not only in terms of their possible adverse effects on competition or equal treatment. Most of these actions require, in one way or another, a considerable budgetary effort by the State, so it is essential to find a mechanism that does not jeopardise the long-term soundness of public finances. Also, great care should be taken that appropriate terms and conditions are required of the institutions which benefit from the measures, and close attention should be paid to the design of suitable mechanisms for monitoring the proper use of the aid.

Having completed my analysis of recent credit behaviour and of the measures taken to deal with the current financial stress, I feel it would be particularly useful to devote the last part of this testimony to commenting on the perspective from which the current credit restrictions in the Spanish economy should be analysed. In my judgment, this analysis should start from two basic premises. The first is the recognition that lending behaviour in Spain cannot be decoupled from the existence of a global financial crisis, the solution to which cannot be signifi-

cantly influenced by us. The second is that the crisis hit Spain at a time when the economy was already in the midst of an adjustment which would in any case have had a major contractionary effect on fund supply and demand.

If these premises are ignored, there is a danger that, driven by a our wish to find a remedy for the financial stress of households and firms, we may make a mistaken diagnosis based on simplistic explanations which leads us to believe that the solution lies in mechanical formulas that, far from providing relief, may, in the final analysis, be counter-productive.

It is not now difficult to identify some of these dangers in the voices and proposals heard in certain countries in favour of economic nationalism and protectionism, based on the false belief that a return to defending the national interest can protect each economy from the affects of a global contractionary spiral. The results of this strategy are well-known: when each country goes its own way and tries to protect itself, the result is to magnify the global recessionary trend. That was the most destructive force in the Great Depression and is a lesson that we should not forget.

Relief from the economic strains necessarily requires concerted and coordinated action between the largest-possible number of countries. This action will have to restore confidence to the financial markets, promote the restructuring of financial institutions and encourage spending. In a framework of freedom of trade and of financial transactions, the coordination of national policies strengthens and multiplies their effects, thereby magnifying the expansionary waves emanating from them. The evident corollary of this reasoning is that any action plan undertaken must necessarily mesh with internationally adopted agreements.

Further, we should not make the mistake of isolating the recent behaviour of lending in Spain from the other factors shaping the current severe adjustment of the Spanish economy. Nothing would be more counter-productive than to take the simplistic view that overcoming the crisis depends solely on the availability of abundant credit financing.

Before anglicisms like subprime, conduit and others became part of our common vocabulary, a series of internal imbalances had been building up in the Spanish economy and eroding its dynamism, making adjustment inevitable. This adjustment might have been gradual if the international circumstances had not changed so dramatically. In any event, given the unfortunate coincidence of the domestic adjustment with extraordinarily adverse external conditions, the recovery of confidence – additionally dented by the exceptional events taking place on a worldwide scale – and the resumption of spending – hit by numerous contractionary factors – will only be possible if the groundwork has been laid for the absorption of the accumulated imbalances.

The resumption of lending undoubtedly forms part of the solution, but this solution requires the right conditions for households and firms to regain confidence in their future income and to lay solid foundations for their plans to embark on consumer spending or investment or, in the case of firms, job creation. On previous occasions I have referred to the current phenomena as the result of the confluence of a series of vicious circles which feed back into each other. Consumers spend less because they are worried about their future income. Firms invest less and recruit fewer workers because they expect less demand and face greater financial difficulties. Banks lend less because they raise less funds and fear for the solvency of borrowers. They are vicious circles which are unlikely to be broken at a single point. The level of confidence and the tone of expectations determine not only spending decisions and the demand for financing, but also the perception of risk and credit standards. And the recovery of confidence in the im-



provement of expectations, although not unrelated to the course of the International crisis, will depend largely on how well the economy can cope with the prevailing adverse circumstances and overcome the current challenges.

We must also realise that, in any possible post-crisis scenario, credit conditions will necessarily be more limited and tighter than before the crisis. During the long expansionary phase, Spanish household and corporate debt grew at rates which the Banco de España repeatedly described as unsustainable. In my judgment, it is unlikely that this economy can find its way back to a path of sound and sustained reactivation of spending without previously making headway in the process of financial restructuring of the private sector now under way.

The Spanish financial system will also have to adapt to these new conditions. Its good overall health is of prime importance to the Spanish economy, but we must take care that such soundness is preserved in the current conditions of financial stress and macroeconomic deterioration. It is not credible to invoke scenarios of recovery of financing flows that are not underpinned by a solid and profitable system of intermediaries. If the Spanish financial system were severely weakened, as has occurred in other countries, the financing of the economy would become even more difficult and growth would suffer to a greater extent.

Moreover, the re-establishment of an appropriate basis for the recovery of confidence and for the resumption of private-sector spending plans largely depends on whether the adjustment to the economy results in improved competitiveness and labour market conditions. After various years of vigorous job creation, we have now moved into a phase in which jobs are being destroyed and unemployment is rising more quickly than in previous recessions. This reflects the persistence of certain structural features of our labour market which do not cause problems when the economy is expanding, but which tend to put the burden of adjustment excessively on employment when the cycle changes. What this contributes to is that consumption contracts more sharply than disposable income and that the contraction in investment is not limited to the residential component, where the need for adjustment is evident, but that it also sharply affects other productive investment. The spillover of contractionary trends driven by rising unemployment is also transmitted to bad debts, bank asset quality and, in short, the tightening of credit conditions. And in these conditions it is very likely that a significant part of the possible expansionary thrust that may be generated will not effectively pass through to spending.

All this is sufficiently illustrative of the complexity underlying the current economic and financial contraction, in the framework of the first global credit crisis in recent economic history. I hope I have been able to get across the idea that the credit strains cannot be considered in isolation. The corollary of this – and here I will finish – is that any effective action programme must prescribe coordinated action on various fronts so as to tackle simultaneously all the not inconsiderable challenges facing the Spanish economy at this time. This is the approach adopted at international level, and we also have to follow suit, adapting it to the particularities of the adjustment process under way and of the specific situation of Spain's financial system.

Thank you

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