Miguel Fernández Ordóñez: Presentation of the 2009 Annual Report

Testimony of Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, to the Parliamentary Committee on Economic and Financial Affairs, on the occasion of the presentation of the 2009 Annual Report, Madrid, 22 June 2010.

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Ladies and gentlemen,

The presentation of the Banco de España Annual Report for 2009 – the reason behind my testimony today – has taken place at an exceptional time for both the Spanish economy and the Economic and Monetary Union. The economic and financial crisis spanning 2008 and 2009, from which most European countries had started to emerge in recent months, has given way to a crisis in the euro area which was triggered by a specific episode, namely the Greek fiscal crisis, but whose systemic implications are proving most severe. In particular, the Spanish economy, along with that of other countries, has been seriously affected by these tensions and it is still too early to know whether the measures adopted in Europe to safeguard EMU and those currently under discussion will be capable of fully dispelling the doubts that have emerged in recent months over the soundness of this institutional framework. The responsibility of national authorities in this respect is also crucial.

In recent years the diagnosis by the Banco de España of the Spanish economy pointed to the presence of major imbalances, which had progressively built up in the long expansionary phase from the mid-1990s to 2007. These problems made it difficult to maintain a sustained growth rate in the medium and long term, and rendered our economy particularly sensitive to the adverse events that might occur. Accordingly, redressing these problems through resolute economic policy action, especially in the area of structural reforms, was unavoidable. Notable among these imbalances was the excessive concentration of resources in the real estate sector and high private-sector debt, which were compounded by the persistence of serious structural deficiencies in the functioning of the labour market. Under these conditions, the 2008 and 2009 recession had a most virulent effect on Spain. This gave rise to a very intense fiscal policy response which, along with the other expansionary economic policy measures, helped soften the adverse effects of the crisis on activity. However, the budget deficit rose to a very high level and did not prevent more severe job destruction than in other countries, despite the fact that the decline in output was on a similar scale. The excessive levels reached by both the budget deficit and the unemployment rate opened up additional fronts of vulnerability in our economy, which was particularly affected by its high dependence on external borrowing, despite the enormous correction the external imbalance has undergone in the past two years.

Against this background, the Greek crisis has undoubtedly had a contagion effect, exposing the weaknesses of the European institutional arrangements and the potential implications for the more vulnerable countries, Spain among them owing to the above-mentioned reasons. Given the scale of the challenges facing us, it is vital that the economic policy response be sufficiently ambitious and resolute, so as to speed the adjustment of the accumulated imbalances and to lay the foundations for a more stable and flexible economy. This would not only be to the benefit of the Spanish economy; it is also essential for the very stability of the common European project.

On this economic policy response will hinge the strength of the recovery, which in Spain's case has hitherto been very incipient and very reliant on temporary stimuli, that will tend to peter out in the short run. Even without the high degree of uncertainty surrounding us in recent weeks, the recovery would only be gradual and would take some time to attain a pace of expansion sufficient to generate employment, which underscores the need to act decisively to avoid prolonged low growth.

The Annual Report of the Banco de España addresses the current situation of and outlook for the Spanish economy in great detail. Accordingly, given the limited time for my testimony, I shall focus on three issues that are essential in my view in order to be able to exit the current situation and bring about a rapid return to sustained growth: fiscal consolidation; the steps that must be taken to set in place an efficient labour market that rapidly promotes job creation; and, lastly, the restructuring of the financial system, where substantial progress has been made in recent weeks.

Evidently, one fundamental challenge we face is the need to correct the strong deterioration of the budgetary position and ensure a rapid return to stability; otherwise, the expansionary momentum of public finances would become an obstacle to recovery. The challenge is an exceptional one since the budget deficit stood at 11.2% of GDP in 2009, up more than 13 pp of GDP in only two years, and there was a substantial increase in the public debt/GDP ratio, which stood at 53.2% in 2009, a level nevertheless below the European average. This marked fiscal deterioration is partly due to the functioning of the automatic stabilisers, the discretionary measures adopted, the strong inertia of public spending and, above all, the decline in revenue linked to the end of the real estate boom, which will be difficult to turn around in the future. This means that much of the fiscal imbalance is structural, and it must be checked urgently with highly ambitious consolidation measures that manage to reverse the trend of spending and build revenue back up.

In other circumstances it would probably have been feasible to reduce the budget deficit more gradually. But at present it is impossible to pursue such a strategy, in a setting in which investors are demanding a speedier return to a credible path of budgetary stability. Responding to this objective is the ambitious package of measures approved by the government on 22 May, complementing the initial consolidation efforts included in the State budget for 2010 and in the updated Stability Programme presented in January this year.

The authorities committed themselves in the updated Stability Programme to reducing the budget deficit to 3% of GDP in 2013, in line with EU requirements under the Stability and Growth Pact.

The package of measures approved in May involves bringing forward to 2010 and 2011 a sizeable portion of the drive to reduce the deficit. As a result, a deficit target of 6% of GDP was set for 2011. This fiscal consolidation objective, entailing a reduction in the deficit of more than 5 pp of GDP in only two years, is exceptional. But it is also vital so as to clearly bring public finances back onto a path of stability and dispel the risks perceived in connection with our fiscal position.

This budget deficit target of 6% of GDP in 2011 should, moreover, be immovable and not conditional upon other factors, even though these are beyond the control of the authorities, such as lower-than-expected economic growth. The financial markets' perception of the likelihood of this objective being met will be a yardstick for the authorities' degree of commitment to pursuing an exit from this crisis, meaning this is the essential factor guiding decisions and budgetary conduct in the coming months. Accordingly, strict compliance with the target must be ensured, both through special budgetary monitoring and surveillance procedures and through additional measures that should be applied if deviations from the target are detected. Naturally, to be in a position to react promptly and effectively, the measures most suited to the objectives set and which least interfere with a return to sustained growth must be designed in advance.

Given the high decentralisation of public spending in Spain, the regional and local governments' participation in this austerity drive and their commitment to attaining budgetary targets are vital. And I must say that the measures announced so far by most of these tiers of government do little to respond to the radical reduction in unproductive public spending that our economy needs.

As I said earlier, the recently approved fiscal adjustment measures were urgent, since they were vital to curb a situation of extremely high instability that might have had disastrous consequences. But there are other measures which, without having the same degree of urgency, are nonetheless more important, since their goal is to ensure medium- and long-term budgetary stability. Clearly, I am referring to the measures to reform our pension system. At an earlier date, the government tabled some proposals in the updated Stability Programme and, on this basis, the Toledo Pact Commission will set about work in the coming weeks. I do not wish to go into details here on the possible avenues of reform. But clearly, a combination of changes that were to raise the legal retirement age, the minimum number of years necessary to qualify for pension benefits and the period over which pensions are calculated would be optimal for ensuring the system's viability.

Pension reform will not entail a significant improvement in the budget deficit figures in the very short term, but it will exert a powerful influence on the recovery of confidence in Spain's economy and in its public sector's solvency, and that will translate into better financing conditions and sounder growth prospects. Therefore, I can but urge that discussions under the aegis of the Toledo Pact take place as promptly as possible, with the widest political consensus, as I believe this may be a key factor for dispelling the uncertainty we have been facing in recent weeks.

The fiscal consolidation programme and the measures adopted to reinforce the institutional arrangements of the Monetary Union are fundamental, but they do not suffice to return the Spanish economy to a path of high growth, particularly following the strong adverse impact the recession has had on all the European countries' potential growth capacity. Consequently, the other centrepiece of the response to the current emergency situation is to adopt a series of structural reforms conducive to the resumption of sustained growth in output and employment. These reforms, in turn, would contribute to progress in fiscal consolidation, as they would enhance the perception of the sustainability of public finances and would reduce the degree of sacrifice implicit in the necessary fiscal austerity that must be maintained in the coming years.

There are several fields in which the Spanish economy requires an overhaul of its structures, to make them more consistent with our membership of a monetary area and with a highly competitive and globalised world economy. Two such fields are the labour market and the financial system, on which I shall elaborate in detail later on in my address.

Correcting the inefficiencies weighing down on the functioning of our labour market is of paramount importance since, as the market is currently structured, the obstacles to gaining competitiveness and generating sustainable employment are patently clear. In particular, these shortcomings have meant that the adjustment of the economy in the recent crisis has fallen disproportionately on employment as a result, among other reasons, of the scant sensitivity of collective bargaining to the specific situation of firms. The extent of these rigidities is not merely cyclical; their effects are largely permanent as they force firms and workers out of the market, causing lasting damage to productive capacity and human capital.

Last week the government approved a series of measures aimed at correcting these inefficiencies, specifically at reducing duality in hiring and at reinforcing companies' internal flexibility. To do this, it opted to amend some of the features of the system currently in place, albeit without altering its most substantial aspects. In particular, the collective bargaining system has remained outside the bounds of the reform; this limits its scope and effectiveness, since the interaction of bargaining with the labour hiring system is a key determinant of the labour market's adjustability.

Notwithstanding, the reform promises headway in terms of internal and wage flexibility that requires proper assessment, since it broadens the scope for firms in difficulty to negotiate wage conditions with their workers that are better suited to the actual situation and to help save jobs. As I have indicated on numerous occasions, had this possibility actually been available during the recent crisis, the labour market adjustment would not have fallen so severely on employment.

In parallel, in order to reduce the duality in hiring, certain measures have been adopted to increase the incentives for permanent hiring. These involve extending the possibilities of using stable employment-promoting contracts and the elimination of some of the causes that encouraged an unwarranted use of dismissals for reasons other than economic ones. The categories of workers that may avail themselves of permanent employment-promoting contracts have also been widened, and certain restrictions on temporary hiring have been introduced. The passage of the reform through Parliament should be used to add greater clarity to the wording of the permanent employment-promoting measures so as to rule out restrictive interpretations and boost its implementation. But the most debatable issue is the imposition of new restrictions on temporary hires, especially if permanent hiring does not improve sufficiently. In the current conditions, with more than 4.5 million Spaniards unemployed, all job creation opportunities must be kept open and not in the least impaired until the new channels for permanent hiring prove effective.

In short, the fiscal consolidation programme, the pension reform proposals and the labour market reform measures are three areas in which significant advances have been made by the authorities in the last few weeks, but in which much work remains to be done. Let me now move on to the area of reform which falls directly under the responsibility of the Banco de España, namely the restructuring of the financial system and, more specifically, of the savings bank sector, where there has been appreciable progress in recent weeks.

In the last few months a very significant portion of Spanish savings banks has concluded merger agreements with other savings banks, in what is the largest restructuring of the Spanish banking sector in a long time. These movements started with the creation of the FROB (the Fund for the Orderly Restructuring of the Banking Sector) in June 2009, nearly two years into the international banking crisis affecting the markets and financial systems of all developed countries, and to which Spanish financial institutions were exhibiting a marked resilience that most have maintained to date.

This new Fund responded to the need to downsize the Spanish banking sector, particularly the savings bank segment. After a prolonged period of growth, this segment had reached a size which, given the evolving demand for banking services, entailed a clear excess of capacity.

From an individual standpoint, the prolongation of the crisis affected the capacity of institutions to generate profits for the following reasons: an increase in non-earning assets (doubtful loans and repossessed real estate assets), the narrowing of margins due to a fall in income associated with rising non-earning assets and to a higher cost of funds, the decrease in business volume, etc.

Moreover, the high growth of previous years, due particularly to increased business with the real estate sector, had raised the dependence on wholesale debt markets, exposing savings banks to the liquidity risk associated with adverse developments in those markets. Compounding this is the intrinsic limitation of savings banks when it comes to raising core capital, a limitation which is important because the trend in both the markets and the prudential financial regulation currently under international revision is clearly towards stepping up requirements in this area.

Given the need to downsize this sector and the conviction that the productive structure of many credit institutions had to be rationalised to hold efficiency at adequate levels in a sector characterised by growing competition, the time was ripe for the creation of the FROB, under whose auspices many savings banks have arranged their mergers or institutional protection systems (hereafter referred to by the Spanish acronym "SIP"). These two forms of action are equivalent insofar as their main effects are concerned, because in SIPs (which are agreements containing clauses to ensure stability) the capacity to define key strategies and policies is transferred to a central entity and the participating credit institutions largely share their net assets and their liquidity, as well as pooling a high proportion of their profits.

The FROB has a second mandate: to participate in the restructuring of unviable credit institutions, acting in this case secondarily to the traditional deposit guarantee funds (DGFs). This dual nature of the FROB and the consequent possibility that a distressed institution not involved in a merger or SIP process may undergo a crisis requiring the Fund to intervene (replacing directors and selling the credit institution or transferring its business to a third party) are an implicit incentive for financial institutions to seek partners with which to conclude merger or SIP agreements.

The FROB has €9 billion in capital and €3 billion of funds from a debt issue and, if needed, it could raise up to €90 billion of funds from third parties.

Since the FROB was set up, a period of 12 months has practically elapsed. The end of this period is marked by the deadline of 30 June 2010 set by the European Commission notification of 28 January 2010 on how to apply the general framework envisaged in it. This time limit applies only to the FROB's competence to assist merger/SIP processes, not to processes of individual restructuring. At the present date, 38 of the 45 Spanish savings banks (39 including Cajasur, a credit institution awaiting a solution within the framework of the FROB) are involved in merger/SIP processes affecting 92% of savings bank assets.

Of the 12 merger/SIP processes, seven are planned with FROB aid estimated at a total of about €10 billion, and the other five without government assistance. Also participating in one of these processes is Caja Castilla-La Mancha, a credit institution seized by the Banco de España which received total aid of €3.8 billion from the deposit guarantee fund (DGF). The merger/SIP plans of these 12 processes have already been authorised by the Banco de España or are at the authorisation stage, except in one case in which three credit institutions are participating in a project still under negotiation but which will not require FROB aid.

The operations involving merger/SIP plans with FROB aid envisage cuts of 20–25% in the number of offices and of around 15% in staff, which gives an idea of the scale of the measures proposed to improve bank efficiency. The structure rationalisation measures are an indispensable requirement for receiving FROB aid and are being included naturally in the other planned voluntary operations, since these measures are responsive to the need to achieve more soundness, more efficiency and more economic rationality.

In addition to these savings bank merger/SIP operations, it should be mentioned that in the three years of international financial crisis, only two savings banks saw their solvency deteriorate to such an extent as to require the application of precautionary special measures.

First, the directors of Caja Castilla-La Mancha were replaced by the Banco de España in March 2009 (before the FROB was set up). It received aid from the DGF totalling €3.8 billion, of which €1.3 billion consisted of preference shares and €2.5 billion were in the form of guarantees of asset value, as well as €350 million of bridge financing. This savings bank, following the agreements reached by it with Cajastur, has joined one of the 12 merger/SIP processes under way.

Second, CajaSur was subjected to compulsory restructuring due to lack of solvency and viability, following its failure to approve a merger with Unicaja, a sound and solvent project in which the two savings banks had agreed on a private solution for the failed institution. The FROB granted temporary aid through the subscription of €800 million of non-voting equity units and €1.5 billion in liquidity support, which so far it has not been necessary to use. Definitive arrangements are being worked out for this savings bank through a competitive process in which the aid finally granted will be defined.

At present, the provisional amount of the aid to be received by Spanish savings banks in this process is as follows. The FROB will furnish around €10 billion to strengthen own funds in merger/SIP processes. This amount has to be repaid within five years (extendable to seven years) and earns the market rate of interest (at least 7.75%). The figure is not final because four processes have yet to be authorised. In addition, Cajasur will receive the aid finally resulting from the competitive procedure.

Furthermore, the savings bank DGF, which is financed by contributions from savings banks, undertook to provide €3.8 billion to Caja Castilla-La Mancha.

These amounts, while substantial, are small compared with those provided by the taxpayers of other countries. Therefore, it is fitting at this point to recall that Spain is now enjoying the benefit of the decision in 1999 to oblige banks to record a general provision: since January 2008 our banks have used some €18.2 billion of this provision to cushion the impact of the crisis on their income statements. As can be seen, this amount is more than the sum of the funds used or to be used by the FROB and the savings bank DGF in the operations described above.

Thus the main decisions have already been taken on the required restructuring and downsizing of the savings bank sector. One task remains in connection with these credit institutions: a legal reform to enable them to issue instruments eligible as top-quality own funds and to provide formulas conducive to improved governance and professionalisation of savings bank management.

The Banco de España's confidence in the soundness and competitiveness of the Spanish banking sector is based on the extensive information we have on the situation of each bank, obtained in the exercise of a supervisory function based on in-depth scrutiny and closeness to the supervised party. We also have the results of regular stress tests of the capacity of banks to cope with possible negative changes in the economic conditions in which they operate. At this moment, as the markets and some sectors of international public opinion are expressing distrust and reservations about the situation of several European financial systems, and particularly Spanish savings banks, the Banco de España has announced its decision to publish the results of stress tests in order to ensure the highest possible transparency of the situation of Spanish banks. Since agreement has been reached in Europe to conduct and publish common stress tests, the Banco de España will join this initiative and, therefore, publish the results of the stress tests on Spanish banks as soon as this common framework allows.

The restructuring and reform of the financial system, together with the budgetary adjustment and the pension and labour market reform, are the most urgent measures needed to restore confidence in the Spanish economy. They should therefore be implemented immediately. But the agenda of reforms required by our economy to move back to steady growth of economic and social well-being and continue modernisation does not end there. There are still important tasks which have to be tackled in unison by all Spanish political, economic and social actors. And, having said that, I cannot conclude without underlining the Banco de España's firm commitment to contribute accordingly.