Miguel Fernández Ordóñez: The crisis and financial markets

Speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the Annual Financial Conference of the Asociación de Mercados Financieros, Madrid, 13 December 2010.

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Good afternoon, and my thanks to the Asociación de Mercados Financieros for their kind invitation to participate in this lunch colloquium.

Since the Great Depression last century, the world has not seen a financial crisis as deep as the present one. And, like then, many years of intense study and a sufficient time perspective will probably be needed to accurately assess the factors that caused the crisis and the mechanisms contributing to its spread. In particular, there is still much to be learned of the relationship between the development of the crisis and the behaviour of financial markets. Nonetheless, I shall take this opportunity today to offer some brief reflections on the conduct of markets during the crisis, with a perspective that in no way claims to be all-encompassing since I shall concern myself exclusively with its impact on the Spanish economy.

To this end I'll discuss two clearly differentiated episodes of the financial crisis of the past three years: the first, which we might call the "banking crisis", affected Spain less than other countries; and the second, associated with the rapid deterioration of public finances in the euro area, has had significant effects on our country.

The outbreak of the first phase of the crisis dates back over three years, when a European bank suspended redemptions of funds invested in US mortgage loans. It soon became apparent that the source of these problems lay in US subprime mortgages and in the spread of the associated risk via the "originate to distribute" model. Banks were hit hardest. Major financial institutions collapsed not only in the countries where the problems originated, but also in many others whose banks invested their savings in products generated by the more indebted economies. By contrast, the Spanish banking system had not originated or invested in this type of product, thanks largely to the relatively conservative approach behind our regulation and supervision. Consequently, although our banks were obviously not immune to some of the effects of the crisis, such as the deterioration in the economic situation or the consequences of the collapse in confidence on the workings of wholesale funding markets, the direct effect on the Spanish banking system was relatively minor.

During the long expansion prior to the crisis, there was a constant increase in the indebtedness of the Spanish economy, similar to that in other countries which, with the crisis, saw their banking systems collapse. Some analysts drew parallels with the events in these countries and warned that similar problems could arise in Spain. But this has not been the case. True, during the expansionary phase, private-sector debt grew at very high rates, although it should be clarified that the growth in asset prices – unwarranted by fundamentals – was less than in other countries. Yet during these three years the Spanish banking system has proven reasonably resilient; only two small entities had to be taken under central bank control, and the volume of public aid made available was very small compared with the public resources earmarked to this end in other countries.

The explanation for this different outcome in apparently similar situations must be sought in the quality of banking regulation and supervision, and in the retail banking-based business model of banks in Spain.

What happened was that the countries which saw their banking systems collapse were largely those which, in the preceding years, had most vigorously defended the benefits of a "hands-off" government approach to the functioning of the financial sector. This was quite the opposite of the approach of the Banco de España, a central bank that took to heart the lessons of the serious banking crises of the 1980s and early 1990s in Spain.

Until the crisis erupted, the prevailing doctrine had advocated light-handed regulation, considering both our supervisory approach and our banking system's business model, centred on traditional banking activities, as outmoded. But in the wake of the crisis, the pendulum has swung. Now the predominant approach in financial regulation has gone to the other extreme. Testifying to this is the work programme in place in the main international agencies and fora, such as the G20, the Financial Stability Board and the Basel Committee on Banking Supervision.

Intense work is under way to introduce major changes into the international regulatory and supervisory framework so as to prevent similar crises from recurring and to improve the financial system's resilience moving forward. Such changes include most notably the new rules known as Basel III, which alter the regulation of the banking sector at the international level in several fundamental respects: banks will be required to have more and better-quality capital; explicit requirements will be made in respect of liquidity risk; and measures will be taken to mitigate the procyclical behaviour of financial activity. Further, the FSB is working on the treatment of systemic banks, i.e. those considered too important to fail due to their size, the level of complexity of their operations or their interconnectedness with other financial system participants. In future, these banks will have to meet greater regulatory and supervisory demands, which will need to be adapted to the type of activity, complexity and structure of each bank. Headway has been made and is being made in many other areas, such as remuneration in the financial sector, the regulation of rating agencies, etc.

Generally speaking, Spain has much to learn from other countries about economic policies. The clearest and most pressing example, in light of the economic and social consequences of the burgeoning number of jobless Spaniards, is the employment and labour market policies of those countries which, even at the height of crises, keep unemployment rates low. However, within the realm of financial regulation and supervision policies, the opposite is the case: our supervisory arrangements are being closely studied for reforms in other countries. The ingenious idea of Governor Rojo and his team to set in place a countercyclical mechanism in order to try and soften credit growth or at least mitigate the adverse consequences of its cyclical behaviour on the banking system was a forerunner of the countercyclical capital buffers envisaged in the Basel III Accord. The constraints on complex products and the obligation to consolidate are further examples of rules or guidelines that are characteristic of Spanish banking supervision and regulation and which fully coincide with the direction in which global financial system reform is advancing.

Spain's approach to restructuring its banking sector has demonstrable advantages. The process has been undertaken using the FROB (Fund for the Orderly Restructuring of the Banking Sector), which was set up following Parliamentary approval over 18 months ago and has since overseen numerous integration processes between savings banks that have reduced their number from 45 to 17. The design of the FROB was based around a two-pronged approach. First, it was geared to supporting banks which, while viable, required restructuring to ensure their ability to resume a path of sustainable profitability, by reinforcing their solvency with public funds. Significantly, in certain countries where the need for a similar instrument has been acknowledged, this has not yet been created. Second, the FROB involved giving the Banco de España wide-ranging powers to swiftly and effectively take control and resolve the problems of those banks that are not viable.

Rounding off the remit of the FROB has been the approval of the reform of the legal regime for savings banks. To date, the limitations inherent in their legal status had prevented savings banks from reinforcing their core capital, except through the capitalisation of profits. The reform opens the way for savings banks to tap private capital by enabling them to issue core equity instruments, it provides for improvements in their management and it subjects them to greater market discipline.

Restructuring was considered on the basis of two criteria that have proven to be most useful. The first is the requirement that those banks applying for public aid should reduce capacity.

During the expansion, our banking system became excessively big in parallel with the growth of the construction sector. If aid had not been conditional upon the presentation of a capacity-adjustment programme, the profit and loss accounts of all banks would have continued to perform poorly, not only in conjunctural terms but also structurally. And as you know, the profit and loss account is the first line of defence when it comes to averting banking crises.

Another criterion that has proven most useful relates to the substantial amount (up to €99 billion) authorised by Parliament to meet the recapitalisation needs that may arise during the crisis, but to contain in turn the budgetary impact of the restructuring process. The more than €10 billion that are to be lent to Spanish banks are no doubt a considerable sum. But it is actually a very small amount when compared with the outlay in other countries, which reacted by pumping towering amounts of public funds into private banks, leading to most serious increases in public debt that in some cases have ultimately caused problems for the country concerned. Where necessary, there are more than sufficient backstops to meet recapitalisation needs, but it is absurd to inject public funds unnecessarily.

Let's now turn to the role of financial markets in the second phase of the financial crisis, the so-called "sovereign debt crisis", which erupted very recently, in spring this year. The behaviour of the sovereign bonds markets could be analysed from the standpoint of market failures or in how they are regulated. While this is an interesting perspective, proposals for reform on any major scale have not yet been set in train, unlike with banking regulation. The crisis has disclosed numerous shortcomings in the functioning of markets, and one frequent criticism is that these same markets influence the public policy agenda. But the fact of the matter is that hardly any far-reaching reforms such as those being drawn up for credit markets have been proposed. Those interested in this viewpoint should read the latest speech by Fernando Restoy, the vice-chairman of the CNMV (Spanish National Securities Market Commission). In it he suggests certain areas in which the regulation of these markets could be improved.

I'm going to adopt a less ambitious approach, focusing on describing market behaviour from the standpoint of a country such as ours, which in recent months has had to tackle a lack of investor confidence.

What have we learned from the behaviour of the debt markets in this second phase of the crisis? Perhaps one of the key lessons is that markets are capable of identifying certain structural problems which, for whatever reason, may affect an economy's solvency. And this is why markets can offer us economic policy pointers, of interest not only to them but also to us. Restoring health to public finances, reforms to boost growth and reduce unemployment, the restructuring of our banking systems so they are positioned to promote growth when credit demand picks up, etc. are all pieces of advice of benefit to us and which are worth following.

Admittedly, some may say, markets issue warnings. But they usually do so belatedly. And this is true. Turning to Spain's case, there was a more than 10-year-long boom during which credit hit double-digit growth rates and the current account, which was practically in balance in 1996, began to run a systematically and continuously widening deficit. Over this period the markets were not exactly profuse in giving signals about the imbalances that were building up. The markets, like Spaniards, thought the Spanish economy was doing fine. We should acknowledge, as Raghuram Rajan does when talking about the US economy, that this delay in realising the actual problems was shared by all agents in the economy. But that does not mean that, although they are late, the messages from markets do not merit being heard and given due assessment. If we think that investors' evaluation of problems is reasonable, then the most recommendable response is to follow their advice.

We've also learned that the markets may not only err when they are late offering their advice, but that their judgments may also be mistaken. Frequently, their information is diffuse or insufficient, and investors' view of different economies is shaped in an overly simplistic fashion. What we've seen, when this is the case, is that criticising their ignorance is of little use in practical terms. The proper response is to provide them with the most and best information possible. Generally, when investors have the right information, they incorporate it appropriately into their judgments.

In all modesty, I think an example of an appropriate response to an incorrect diagnosis by the markets was our decision last summer to perform stress tests on all listed Spanish banks and savings banks. The markets' doubts at that time about the Spanish system's capacity to digest the real estate problem were unfounded. But once we reacted, transparently, the uncertainty dispelled, banks and savings banks were once again able to raise funds on markets and the recourse by our banks to ECB financing dropped dramatically.

In this same vein of lessons learned, we've recently seen that the markets, in addition to not being infallible, also sometimes forget. The latest instance of this are the doubts that have emerged again about the Spanish banking system. The stress tests were performed at the end of July, and as you may well suppose, the value of Spanish banks' real estate assets cannot have varied significantly in three months. Nothing has changed substantially in respect of the other assumptions made, and yet the markets appear to have forgotten this because they have adopted a line of logic that has it that if Ireland had a real estate problem and has serious banking problems, something similar might happen in Spain. This suspicion has been strengthened by the fact that Irish banks also passed the stress tests. In this respect, it should be underscored that the stress tests performed in Spain were more exhaustive and offered more detailed information. While in Ireland only two banks participated in the tests, in Spain all listed banks and savings banks took part and information was provided on the exposure to risks, real estate risk in particular, with a notably greater degree of detail and transparency than in other countries.

But what is to be done when markets forget or investors' doubts resurface? Once again in these cases, the medicine should be more transparency. This is why, in late November, we took the initiative of explaining again the situation and we once more laid bare Spanish banks, and savings banks in particular. We have asked banks to explain in detail their situation to the market. In particular, the Banco de España has given instructions to the related banking associations to ensure that institutions disclose standardised additional information on a quarterly basis to the market on their exposure to the real estate development and construction sector, detailing the percentages of doubtful loans, the related collateral and the provisions set aside to withstand their potential impairment. They also have to give details of their retail mortgage portfolio, including the related LTV ratios and the percentages of doubtful assets. Finally, they must assess their market funding needs and the short-, medium- and long-term strategies they have implemented. All this is necessary because when reality is perceived as being worse than it actually is, the best possible response is to explain it in the finest detail.

A further lesson drawn from the conduct of markets is that they do not like uncertainty. As top film scriptwriters know, filmgoers are happiest when they can predict a little bit of what's going to happen. Music composers also know this. The more unpredictable a film or a musical composition is, the more unsatisfied viewers and listeners are. In this debt crisis, in addition to the responsibility of the countries subjected to market mistrust, the lack of coordination among European Union leaders has also played a key role. In the public eye, the latter have aired substantial differences and have sometimes done so at the worst possible time in the crisis, thereby contributing to compounding the problems. I recall a journalist interviewing an analyst in a US TV programme some weeks back. The analysts set about discussing how Europe's sovereign debt problems were the main source of instability at present worldwide. The journalists asked him how it was possible that, among the markets' reasons for nervousness, he had not even mentioned the North Korean bombing incident the previous day. And the analyst replied: "Look, markets like predictable. And the North Korean government is much more predictable than European politicians".

What I have said about European Union institutions can also be extended to institutions within individual countries, where it is not only important what the central government says or does, but also what the regional governments, the opposition and, generally, all relevant economic agents do or say. And that's something else we've learned about markets: they see us from afar and don't distinguish what we distinguish within. Specifically, in our case, they do not always draw a distinction between regional and central governments, or between the government and the opposition. What they see is, simply, Spain.

Taking these lessons on market behaviour to heart is very important for all countries, but all the more so in a country such as Spain which, owing to the systematic and growing build-up of current account deficits since 1996, has had to resort to external financing. Accordingly, it is vital to transmit confidence to those who finance us.

We're now moving in the right direction. In the space of three years we've moved from a current account deficit of around 10% of GDP to one below 5% this year. And in the case of the budget deficit, we'll see a decline from over 11% last year to 6% next year. Once the adjustment is over, the Spanish economy will once again outgrow the biggest economies in the euro area, as foreseen by most international institutions. Yet we should not be complacent, but carry on pushing structural reforms through.

You'll have noted that the markets behave like people: sometimes they give reasonable advice, sometimes they do so late, sometimes they make mistakes, and sometimes they have a short memory. And they waver between greed and fear, depending on whether they're preoccupied with returns or with risk. We're now witnessing a "flight from risk". But you'll no doubt recall the frenzied "search for yield" on financial markets worldwide in the decade prior to the crisis.

Should we always heed the advice of the markets? Not necessarily. It's highly recommendable to do so when their messages are sensible ones. And frequently, albeit belatedly, they demand we do what benefits us. But they also make mistakes occasionally and, in those cases, there's no sense in our getting worked up and calling them ignorant. That serves no purpose. The right response is to offer them the most information possible and to explain to them our reasoning. This is how to convince somebody, and it is how we should react to the markets. Indeed, the markets are no more than people. That is why when I'm asked how we should react to them, my usual advice is to treat them like the people they ultimately are.

Thank you.