Miguel Fernández Ordóñez: Seeking solutions to Spain's economic, financial and fiscal issues

Address by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, to the Annual Assembly of the Instituto de Empresa Familiar (IEF) Madrid, 23 May 2011.

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Many thanks for inviting me to talk at your Assembly. And since one of the functions of your Institute is to seek solutions to the legal and institutional environment in which the company moves, I've decided to focus my address today on what I think about this matter.

Resolving a country's economic problems should be no different from what any individual or company does to improve its situation. First, acknowledge that we have problems; second, identify the changes needed; and third, apply them. I'll try to apply these guidelines to what, in my view, are our main problems: the relatively low level of educational attainment of the labour force; the need to adjust the imbalances accumulated over the course of 14 years of expansion; massive unemployment; and, for a year now, the mistrust of the markets to which we have to resort for funding. Let's begin by looking at two examples where problems were not properly identified.

The first of these was thinking that the main source of our difficulties was the international financial crisis and not the imbalances accumulated further to a long expansion based on indebtedness and the deterioration of our competitiveness. Undeniably, the international crisis worsened our economy's situation by prompting a worldwide recession and the closure of the funding markets. But, as we now fortunately acknowledge, in Spain we had our own problems that needed resolving.

Another example of not realising or not wishing to acknowledge problems can be seen in those who claim that, to redress our high budget deficit, it is not vital to make spending cuts. It's not right to say that spending cuts, appropriately adopted in my view by the central government and by certain regional governments, were not needed. A responsible attitude should lead to recognition that it is not possible to reduce a deficit that had climbed to 11% to 3% of GDP without making far-reaching cuts in public spending.

As to the second task, namely the search for solutions to resolve our problems, our Parliament has correctly identified two of the changes needed to tackle the problems created by the imbalances incubated during the expansionary phase: the reduction of the budget deficit and the restructuring of part of our banking system. As regards fiscal consolidation, the Stability Programme that has targeted a deficit of 3% by 2013 is an ambitious plan. It has been recognised by the European Union and has been met in its first year. Accordingly, all tiers of government – central, regional and local alike – must rigorously fulfil the targets set for the current and coming years.

Turning to the identification of the problems posed by part of our banking system, the government and Parliament reacted promptly. As early as 2009 the FROB (Fund for the Orderly Restructuring of the Banking Sector) legislation was approved, allowing the start of the restructuring of an extensive number of savings banks. And, whenever necessary, the government and Parliament have not hesitated to adopt further legislation so as to speed through and conclude this process, as evidenced by the approval of the Savings Bank Law in 2010 and, more recently, the passing of the Royal Decree-Law on the capitalisation of our credit institutions. The fact these regulations have been approved with an acceptable degree of Parliamentary consensus is most positive.

In this case, as in that of cutting the deficit, it is expected that savings bank restructuring will be completed how and when the Parliament has decreed. Despite affecting a limited part of the banking system, the restructuring has generated such noise that the doubts as to whether the legislator should have adopted more drastic solutions are understandable. But I should say that some of the alternatives, such as injecting capital into the savings banks without making this conditional upon their restructuring and resizing, might have entailed more disadvantages than advantages, compared with the option actually chosen by the legislator.

Unlike other countries which found that their major banks had collapsed practically from one day to the next, the problem of the Spanish banking system was confined to a part of the savings bank sector. And I stress "a part", since some of our savings banks are perfectly sound when set against the commercial banks. However, during the upturn some savings banks had pursued a model centred on high credit growth with high exposure to the real estate development and construction sector. With the arrival of the crisis, the shortcomings of this model became clearly evident. In the new setting, with a rapid deterioration in asset quality, with margins diminishing and with business volume expectations much lower than in the past, it could be seen that it was essential to restructure balance sheets and reduce the sector's capacity, which had expanded in prior years in parallel with the buoyancy of credit. Patently, too, these institutions were excessively fragmented, which increased their difficulties in raising finance on the wholesale funding markets. Finally, the crisis also brought to light the obstacles arising from the corporate structure of savings banks, which prevented them from raising high-quality capital on the markets and which, frequently, did not provide sufficiently for best-practice governance arrangements.

Had capital been injected into the savings banks without making such aid conditional upon what is inevitably a longer, riskier and more complex process of restructuring these institutions, that would have been of no use in resolving our main problems. Therefore, it was opted to establish this conditionality and to promote an integration process designed to bring about sizes that would enable the institutions to be more efficient and to more readily obtain funding from the markets; to implement capacity-reduction plans; to introduce management changes; to write down balance sheets with a charge to private funds; to convert savings banks into banks, and to raise capital on the markets. True, a plan of this scale and complexity does not enable difficulties to be overcome overnight. Yet it is not an overstatement to say that, once the process has been concluded, it will have brought about a reform that should be valid for many years.

Let's now look at our economy's biggest problem: the difficulties our legal and institutional framework poses for job creation and which mean that, even in good times, Spain is one of the countries with the highest unemployment rates in the world. Earlier I referred to the importance of identifying and acknowledging problems. It suffices to look at the figures available and, in particular, at our very high unemployment rate – at 21.3% – to see that we have a serious home-grown problem, stemming from the shortcomings of our legal and institutional framework. Pick up a copy of *The Economist* and go to the final pages, where there is a table with the economic data for the 40 biggest economies in the world. You'll see that the vast majority of these countries have unemployment rates below 10% and that only two of them, Spain and South Africa, surpass the striking 20% threshold. Sometimes these high figures are attributed to other structural factors, such as the lower level of educational attainment and productivity. On other occasions, more conjunctural factors such as the real estate bubble are mentioned. But if we compare ourselves with other countries, the difference is a legal and institutional framework that seriously hampers labour supply. Because, as you can see, these 40 countries include the developed and less developed; some that have not had a real estate bubble and others that have, even bigger than Spain's; some with a higher level of educational attainment than Spain, but many others far below us; countries with high productivity per employee, but others with much lower productivity than Spain. And yet, as I said, most of them have single-figure unemployment rates, at less than half the Spanish rate.

But perhaps where it can be most clearly seen why our unemployment problem is caused by a singular institutional and legal framework that hampers employment is the performance of unemployment not at times of crisis as at present, but during boom periods. As you know, the lowest unemployment rate we have achieved, namely 8% in mid-2007, is far higher than that in the other European economies when their growth was highest.

This is why it's crucial to eliminate the obstacles to offering jobs to young and old, to everybody in fact. With the right institutions in place, not only would entrepreneurs be able to offer a higher number of jobs that were profitable for their companies but, more importantly, workers would have the option to decide whether they wanted to accept these jobs or not. Because the problem now is that, with no jobs being offered, they do not even have the possibility of deciding.

It is sometimes claimed that, whatever our legal and institutional framework, unemployment can only fall if we manage to substantially raise the GDP growth rate. Admittedly, past experience shows that, on average, the Spanish economy has created jobs when it has been able to grow at over 2%. But these relationships are not unmovable since they are precisely an outcome of the institutional framework in place. If structural changes are made to eliminate the obstacles to offering jobs, lower unemployment rates with lower GDP growth rates may be attained.

The reforms aimed at increasing the supply of jobs are, moreover, absolutely unavoidable now we are in the Monetary Union. And this should be stressed because, although I believe there is broad consensus on the need to adjust our economy, there is still not sufficient recognition that this adjustment must be different from those made when we had the possibility of devaluing our currency. Back then employment could be generated through the reduction in wage costs that a devaluation entailed and thanks to the improvement in competitiveness that immediately came about in companies. But this formula is no longer viable, and thankfully so, because the benefits for Spain of being part of the euro far outweigh those of retaining the peseta in the long run. But if we accept this constraint now upon us, we must be consistent and accept that this time we can no longer, as we did on several occasions in the past, adjust our competitiveness and, therefore, increase our growth rate without changing our singular institutional framework.

And in this forum I should mention the responsibility that large and small firms alike must embrace. With all due diligence they should adopt the organisational reforms and adapt their working procedures so as to enable them to use as soon as possible all the changes introduced into our legal and institutional framework aimed at making hiring easier.

Let me move on now to the problems I mentioned at the start of my address. These concern the markets' doubts, reflected in the higher cost that the Kingdom of Spain has been paying for a year to raise funding. Blaming this on greedy or evil markets would be a waste of time, and might distract us from the fact that these costs can only be reduced if we adopt the domestic measures and reforms needed as soon as possible. True, there are other external factors that generate what is occasionally unwarranted mistrust of the Kingdom of Spain. Undoubtedly, factors such as market irrationality, herding or procyclicality are significant, but they will not foreseeably change. There are also other factors, such as the mistakes made by European Union Member States when attempting to resolve their problems, that are no doubt also responsible for this higher cost, and the proof is that the sense of incapacity being conveyed to the markets does not only affect our country, as shown by the abnormally high level of most euro area countries' CDSs. But it must also be accepted that the possibility of improving economic governance in Europe is in the hands of many other countries and not only Spain.

This is why we should focus on easing the concerns of the markets, which do largely depend on us. These concerns are those that I have mentioned: there are doubts as to whether we will be capable of seeing through the fiscal adjustment, concluding the restructuring of savings banks and changing the institutional framework in a way conducive to job creation in Spain. As to the fiscal adjustment and to financial restructuring, I believe the means and the schedule set by Parliament are correct, and now it's a question of complying. However, in the case of improving the supply of jobs in Spain, there must be an urgent recognition of our problems by all, and reform measures should be adopted as soon as possible. From December to March the markets acknowledged the last two measures adopted in the fiscal and financial field, namely pension reform and the Royal Decree-Law on recapitalisation. Yet the figures of more than 20% for total unemployment and of around 40% for youth unemployment continue to appear on all market screens, figures that investors consider to be a sign of inability to promptly attain close to potential growth.

We have to change the institutional and legal framework of employment not because the markets demand it, but because it is in our interest. All citizens want lower unemployment rates and higher wages in those industries or companies where productivity is growing more. But we must also be aware that if the obstacles to job creation are not lifted, the markets will ultimately perceive that the only way Spain can recover competitiveness within the Monetary Union will be by maintaining very low GDP growth rates over many years, as has occurred in other countries. The solution to fiscal problems, no matter how appropriate the policies adopted are, will be much more complicated if public revenue is poor or if we carry on spending 3% of GDP on transfers to the unemployed for any length of time. Likewise, in the case of the financial system, restructuring will be slower if low growth diminishes the volume of banking business and increases bad debts.

We should not accept having to pay a spread of around 200 basis points for much longer. This not only increases the portion of public spending set aside to pay interest but, above all, it might ultimately hamper business financing, reducing the supply of credit and raising its cost. To date, credit figures have behaved in Spain as the macroeconomic models might have predicted. After a long phase of excessive debt, households and firms must deleverage, and logically their demand for credit should be contained. And as was likewise to be expected, the reduction in credit is affecting those sectors such as construction and real estate more adversely than other sectors which are even recording positive growth in credit. Past experience also teaches us that we will only see an increase in the solvent demand for credit that is higher than nominal GDP growth when sufficient time has elapsed since the cyclical trough in the economy. All this is true but, if we do not sufficiently narrow the Kingdom of Spain’s spread, complying with our fiscal and financial commitments and changing our institutional framework for employment, credit developments in Spain may be affected not only by the lack of momentum of solvent demand, but also by supply-side limitations.

I would like to conclude on an optimistic note. I am convinced that, just as the need for fiscal consolidation or pension reform was ultimately recognised, so too will the unavoidable need to change our legal and institutional framework in such a way as to allow entrepreneurs to increase the supply of jobs and workers to decide whether to take them. In the past 50 years, Spain has made numerous reforms across its economic structure. Tariffs have been lifted and companies privatised, and competition has been fomented in many industries. Yet the institutional framework for employment has remained practically and essentially unchanged since the onset of democracy. Meanwhile, in recent decades, other economies, most notably the Nordic countries, have introduced so-called flexicurity, i.e. they have introduced the flexibility needed to reduce the unemployment rate and to increase wages where productivity is growing most, and they have at the same time maintained and even strengthened the social protection which is a hallmark of our European model of society.

Finally, the measures I have mentioned are not the only ones that should be adopted. The reform agenda is an extensive one. For instance, it is essential to reduce administrative burdens, to simplify and coordinate economic regulation, and to alter oligopolistic structures, as was recently recommended by the Competition Board for the case of oil products. We could draw up a very extensive list of measures, but you will understand – and I hope appreciate – that, with limited time at my disposal, I have confined myself to what I consider most important and pressing.

Given the importance of the matter, I cannot conclude without referring to our level of educational attainment and, specifically, to secondary education. Unfortunately, the measures that raise educational attainment pose a problem; unlike the reforms we have looked at today, the effects of potential improvements in education are very slow and this explains why the attention the subject requires is continuously put off. But this slowness in bearing fruit is precisely what justifies the need to undertake this task as soon as possible and, while waiting, we should reiterate that education is the most important problem facing our society and our economy in the medium term.

Thank you very much.