Miguel Fernández Ordóñez: Presentation of the 2010 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 2010 Annual Report, Madrid, 21 June 2011.

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Ladies and gentlemen,

I appear before you today on the occasion of the presentation of the 2010 Annual Report. As was the case last year when I gave testimony, the circumstances surrounding us remain complicated. It would not be overstating the case to say we are at a crucial crossroads for the future of the economic and monetary union and for the anchoring of the recovery in Spain.

The crisis that broke in the summer of 2007 has gone through various phases and is bringing major consequences to bear. A year back, before this Committee, I spoke of the events that had shaken the euro area in the spring of 2010, with the emergence of the sovereign debt crisis, the response of the authorities with the approval of the financial assistance programme for Greece, and the first steps towards the reform of the euro area governance mechanisms. The effects of the crisis on the Spanish economy were very serious, but economic policy responded with an ambitious fiscal adjustment plan, fresh impetus to the financial restructuring process and the launch of structural reforms in various fields. Set against the serious circumstances then facing Spain, it may be said that the right approach was chosen, and the initiatives adopted helped mitigate the risks that had materialised. Despite this favourable change of course, the situation twelve months on remains complex, both from the European perspective and from the domestic standpoint of the Spanish economy.

The European sovereign debt crisis is the most serious episode to impact the euro area since the single currency was founded. Its very nature and the difficulties in tackling it have, moreover, highlighted the shortcomings of the institutional framework of the euro. These include most notably the insufficient degree of fiscal discipline imposed by the Stability and Growth Pact, the absence of mechanisms to check the build-up of macroeconomic imbalances and the lack of tools with which to manage crisis situations such as those witnessed.

Yet we must also acknowledge that there has been significant progress in recent months in these three areas. There have been various legislative initiatives to reinforce the Stability and Growth Pact, to establish arrangements for the prevention and correction of macroeconomic (other than fiscal) imbalances and, finally, to address crisis situations with the so-called European Stability Mechanism.

But beyond the necessary reform of the economic governance of the euro, the difficult position of the Irish, Portuguese and, above all, Greek economies must be redressed. Tensions are at a peak and the outcome of the situation may have very important consequences for the euro area as a whole.

It is often acknowledged that European construction has been forged through the overcoming of recurrent episodes of crisis, from which the project has always emerged strengthened. Let us hope this is true this time and that the European authorities' decisions will rise to the challenge.

The Spanish economy was particularly affected by the sovereign debt crisis when the Greek and Irish economies had to resort to adjustment programmes. Conversely, when the same happened with Portugal in April this year, the impact was less, despite our closer economic, trade and financial ties with this country. This was due to the set of measures that had been adopted previously to speed the approval of some reforms and thus tackle confidence problems. In any event, the Spanish economy remains under the scrutiny of the markets, which continue to demand an unjustifiably high level of sovereign risk premia. In past weeks we have witnessed the effect caused by the recent discussions in Europe on the potential participation of the private sector in the bail-out of the Greek economy, while doubts resurfaced over the seriousness of Spain's commitment to pushing through outstanding reforms.

The spread of the sovereign debt crisis to Spain was ultimately due to the presence in our country of certain factors of vulnerability as a result of the imbalances that had built up during the previous upturn. And these were compounded by the factors that had emerged during the crisis, such as the high unemployment rate and the burgeoning budget deficit.

The main imbalances accumulated in the phase of strong growth were attributable to a sharp expansion in demand that gave rise to a substantial increase in private-sector debt, excesses in the real estate sector, and price and cost increases that tended to crowd out domestic output in favour of imports, systematically raising the external deficit.

The unfolding of the economic crisis further complicated the situation. Firstly, because it gave rise to severe job destruction, as a result of shortcomings in the workings of the labour market. At 21%, the unemployment level has not only highlighted the need to reform the institutional framework of this market; the figure also raises doubts about the Spanish economy's capacity to restore its potential growth and ensure the sustainability of its public finances.

In this respect, the rapid fiscal deterioration has been one of the factors that has increased our country's exposure to the euro area debt crisis. Our starting point was a healthy one, with a budget surplus in 2007 and a low public debt ratio. But the deterioration was so sharp that, in the space of scarcely two years, the deficit climbed above 11% of GDP and debt moved into a delicate dynamic just as the financial markets began to worry about the expansionary deviation of public finances in other countries. In this climate of nervousness, the high levels of private-sector debt, the need for balance-sheet write-downs in the financial sector and the difficulty the economy faced in growing at a sufficiently high level all weighed on the perception of the sustainability of our public finances.

Moreover, the banking system, which had negotiated the first wave of the international financial crisis without excessive difficulties, came up against bigger problems when the main elements of the underlying macroeconomic crisis began to be felt at banks. Combining with this was the tightening of financing conditions for credit institutions raising funds abroad, as a result of the prevailing instability on financial markets.

Faced with all these circumstances, it was vital to firmly show that matters could be turned around and that Spain was not bound to follow the path of instability of other countries. To do this, the change in economic policy stance last spring was essential, since it demonstrated a willingness to react to and redress the imbalances.

Given the source of the tensions, the priority was to right the trajectory of public finances. To this end, an ambitious fiscal consolidation plan was approved in May last year. It brought forward the bulk of the adjustment to be made to the years 2010 and 2011. In parallel, there was a patent and pressing need to tackle the labour market shortcomings that were hampering the absorption of unemployment and the adjustment of the economy. Hence a labour market reform was launched. Finally, in the financial field, the restructuring initiated a year earlier was accelerated to overhaul the savings bank sector.

Thanks to these measures, the recovery of the Spanish economy remained on track, although it continued at a slow pace, due to the very need to undertake unavoidable adjustments. In this respect, the weight of real estate activity in output continued to decline and the external deficit was also further corrected. There was no significant progress in inflation, but this was due to the influence of temporary factors, such as the rise in VAT in

July last year and the hike in oil and other commodities prices. Once these effects have worked through, inflation should fall again in the coming months, although for this to happen it will be vital no second-round effects should come about, as these would harm the economy's competitiveness.

Write-downs of the balance sheets of non-financial corporations and households have continued, with a slight decline in the outstanding balance of credit extended to these agents. In the case of non-financial corporations, behaviour has differed across the productive sectors, with modest increases in financing to companies other than those in real estate development and construction. In the case of households, deleveraging will no doubt be slower, insofar as the bulk of household debts are in mortgage loans extended over long terms, whereby repayment will be gradual.

Adjustment of the imbalances in the economy is vital in order to soundly underpin medium and long-term growth, although in the short run, balance-sheet write-downs in the general government sector, at credit institutions and in households and firms may check any take-off in spending. Fortunately, the sluggishness of domestic demand is being offset by the buoyancy of external demand. The thrust of exports has been substantial and should continue to be so, whereby attaining further gains in competitiveness will be vital. This is the key variable for making the adjustment of the imbalances compatible with the firming of a more dynamic recovery.

If this combination of adjustment and growth were to successfully take root, the Spanish economy could see private-sector deleveraging, the stabilising of public finances and the restructuring of the banking system lead to an increase in confidence, softer financial conditions and, in sum, an improved economic outlook that would boost investment and employment.

The role of economic policy remains pivotal for steering the adjustment process. In the case of fiscal policy, the measures adopted last spring marked the starting point. But substantial challenges lie ahead and determination will be required to define and specify the measures that allow public finances to resume a stable path. In the short run, the deficit target for 2011 is ambitious, as it entails a reduction of more than 3 pp of GDP to 6%. But, at the same time, compliance is crucial in view of the financial markets' extreme sensitivity to the course of public finances. A great effort is needed but, as we have so much at stake, it is vital to prevent deviations from these targets from arising and, should they do so, the necessary measures must immediately be implemented to correct them, as the government has undertaken to do.

To see this task through, all levels of government must be involved. This begins with the regional governments, who must firmly redress their budgetary positions, in which connection the strict arrangements for the authorisation of indebtedness may prove helpful. Another confidence-building factor would be greater transparency of regional government budgetary information. True, significant headway has recently been made in this area. But, to dispel doubts about the state of regional finances, it would be very important to see the regular publication of figures for the regional governments as a whole and for each particular region, with the same periodicity, degree of detail, lag and accessibility as State figures.

The heavy deterioration in the general government deficit in this crisis advises, moreover, adopting measures to achieve a more balanced budgetary performance both in upturns and in recessions. Here, the government announcement to include in the Budgetary Stability Law a rule whereby general government spending may not exceed the medium-term growth rate of the Spanish economy is most positive. This rule would be immediately applicable to central and to local government, but its adoption by the regional governments would also be pursued.

Fiscal sustainability also needs the economy to swiftly restore its dynamism and to achieve a high potential rate, since this is a fundamental means of financing the public spending increases to which population ageing is inevitably going to lead. The proposed pension system reform submitted by the government in January this year is also a key step towards curbing these costs. The financial markets have understood that this reform strengthens fiscal sustainability, so it would be advisable to set this proposal down in the form of legislation as soon as possible. Further, the sustainability to which the reform refers should be specified, so that a procedure is in place to ensure at all times that pensions growth is on a sustainable path.

On the financial front, further headway in restructuring the banking sector has been made in 2010 and in 2011 to date. The most significant regulatory step here was the creation, in 2009, of the Fund for the Orderly Restructuring of the Banking Sector (FROB). The FROB has proven most useful in paving the way for merger and integration processes in the savings bank sector, which was highly fragmented. As a result, the number of institutions in the sector has fallen relatively quickly from 45 to 18. In those operations that received funds from the FROB, the institutions concerned submitted restructuring plans that envisage reductions in the number of offices and in other operating expenses.

Other major steps in banking system restructuring have been the reform of the legal regime governing savings banks, approved last summer. And more recently, in February this year, Royal Decree-Law 2/2011 was enacted. This raised the minimum required level of top-quality capital for all credit institutions. It encourages tapping the markets for funds, either through market launches or through the entry of new investors, although the FROB is authorised to inject the capital needed in those cases in which banks cannot meet the new requirements through resort to the markets. This recapitalisation strategy encouraging the entry of private investors into savings banks requires time and effort by all concerned. But it offers clear advantages in the medium and long term as regards the cost to taxpayers and, above all, the soundness and durability of new projects, compared with the nationalisations used in other countries, where problems differed and it was not necessary to pursue beforehand a strategy based on the rationalisation of the weakest institutions to attain gains in efficiency, size and governance.

Recapitalisation is moving ahead under the terms and timeframe envisaged in Royal Decree-Law 2/2011. On 11 March, the Banco de España published the capital needed by all institutions to comply with this legislation. Most commercial banks and half of the Spanish savings banks met the requirements laid down. Following the collapse of one of the integration projects, 13 institutions – commercial banks and savings banks – needed to increase their capital. On 14 April, the Banco de España approved the strategies and timeframes submitted by these 13 institutions. Two of them were the subsidiaries of foreign banks that are being recapitalised by their parents. A further two Spanish banks opted to reinforce their capital by tapping the market. Of the remaining institutions, namely nine savings banks or groups of savings banks. four opted as a primary alternative to increase their capital resorting to the markets, and, as a second option, resorting to the FROB. Another savings bank decided to participate in an integration process with a better capitalised institution. Finally, the remaining four savings banks that had to increase their capital to meet the new requirements chose the FROB as their primary option.

The institutions opting to tap the markets, whether through IPOs or through private investors taking a stake in their capital, are currently immersed in the process associated with this strategy. In the case of savings banks that have resorted to the FROB to recapitalise, the business and recapitalisation plans are being analysed, and the valuation of these institutions by independent experts is under way. Accordingly, the entire process is moving ahead as scheduled in the legislation, which stipulates that the new requirements shall be met by 30 September this year, although institutions opting for private investment may apply for a three-month extension, extendible to six months in the case of market listings. Significantly, the recapitalisation process has been accompanied by the transformation of most savings banks into banks, a move that has gone outside and beyond the group of institutions that had to increase their capital to meet the new requirements.

The Banco de España considers that the capital requirements laid down by Royal Decree-Law 2/2011 are sufficient to ensure the soundness of the Spanish banking system, not only under the most likely macroeconomic scenario, but also under harsher scenarios that are most unlikely to occur. As is known, some analysts estimated that the capital needs of our banking system may be greater in the future, under assumptions of a strong deterioration in the Spanish economy. In this respect, the stress tests being conducted at the European level will show to what extent banks need more capital to withstand the extreme scenarios envisaged in these tests. If, as a result of these tests, certain Spanish banks were to evidence additional capital needs that could not be covered by the banks themselves through resort to the markets or to other means, the FROB would provide the funds required, as envisaged in the Royal Decree. In any event, even under highly pessimistic scenarios about the Spanish economy, the use of public funds to recapitalise institutions would entail only a relatively moderate increase in the outstanding balance of Spanish public debt.

The restructuring and recapitalisation of the banking system has been accompanied by a significant drive to write down the balance sheets of Spanish deposit institutions which, since January 2008, have recognised and assumed asset impairment losses totalling €96 billion, equivalent to 9% of GDP.

Lastly, I should like to stress the progress made in transparency and the significant role this tool has played. In particular, I should remind you that the Europe-wide coordinated stress tests conducted last year were subject in Spain to substantially higher coverage than in other countries. Indeed, the results of all savings banks and all listed commercial banks were published. Consequently, analysts and the public at large have all the information they need to evaluate and assess the situation of even the smallest Spanish institutions, something which cannot be done in other countries. Moreover, the Banco de España required all institutions to publish in detail their exposures to the most troubled assets, along with their volumes of wholesale funding and their liquidity situation. Lastly, another area in which the degree of transparency in Spain is comparatively greater is that relating to provisioning since, unlike standard practice in other countries, the methodologies for provision-measurement and provisioning requirements are public.

Transparency is a most useful tool in financial system restructuring because it helps dispel doubts about the soundness of the Spanish banking sector, it enables public opinion to better understand the need to overhaul the savings banks sector, and it encourages managers and the attendant authorities to promptly undertake the necessary restructuring process.

The Spanish economy faces considerable challenges, which I have reviewed today. But the most pressing task undoubtedly lies in our labour market, the workings of which evidence singular traits compared with those of other countries. In times of crisis such as the present, these traits lead to the adjustment coming about essentially through job destruction and, even in boom times, the unemployment rate holds at an unjustifiably high level. To reduce such high unemployment and to rapidly generate jobs again, we must draw our institutional and legal framework closer to the models of the other developed countries, which allow for greater flexibility in the use of the labour factor with a greater degree of worker protection. In fact, within the euro, the key variable for the recovery of the Spanish economy is competitiveness. And without a far-reaching reform of these institutions, it will be very difficult for the Spanish economy to promptly attain a reasonable rate of sustained growth.

On 10 June the government approved a Decree-Law providing for some improvement to the regulation of collective bargaining. Foreseeably, in its passage through Parliament, greater powers will be extended to workers and employers so that, in mutual agreement, they may decide what they believe is most suitable to enhance the productivity and competitiveness of their companies. The positive effects of this greater flexibility in the labour market would be reinforced if, moreover, measures were taken to increase competition in the markets for goods and services.

In sum, we are at a juncture where achieving the right monetary and fiscal stance and successfully managing economic policy will be pivotal for the future of the Spanish economy. The course the European sovereign debt crisis takes will be a determinant of paramount importance. But whatever the scenario the role of our economic policy will remain fundamental for overcoming the inefficiencies highlighted, for redressing the lack of confidence hampering and raising the cost of external funding, and for keeping the Spanish economy safe from any incident that might occur in the European arena.