Miguel Fernández Ordóñez: Facing the crisis in Europe

Opening address by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the Conference in memory of Luis Ángel Rojo, Madrid, 21 February 2012.

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Good morning, and many thanks for having accepted our invitation to participate in this Conference in memory of Ángel Rojo. Presiding over this tribute by the Banco de España, to which Ángel Rojo devoted much of his peerless personal and professional calibre, and in which he developed many of his analytical and intellectual contributions, is frankly a privilege I would have preferred never to have taken up. It was in the Bank where he was able to successfully transform macroeconomic thought into economic policy design and implementation, heightening the reputation of the Bank itself and no doubt contributing to enhancing the well-being of Spaniards.

The Bank wanted this tribute to be as solemn an occasion as the key role Ángel Rojo played within it merits, and that it should be worthy of the deep impression he made and the valuable legacy he bestowed upon us, which all his followers have sought to preserve. Fortunately for future generations, the guiding principles of his thinking as Governor can be found in numerous written texts taken from conferences and speeches that greatly impacted Spanish society and the economic policy debate in a singularly important phase for the modernisation of our economy. One of the first means of paying tribute to him that occurred to us was to publish a book with a broad selection of these texts. On reading it you will see how many of the subjects he tackled over the course of his term of office, from 1992 to 2000, remain fully valid in today's economic debate.

Along with the publication of this book we decided to hold this Conference as a tribute, structuring it around a discussion of the pivotal areas of Ángel Rojo's economic thought. We are joined by a select group of speakers whose common denominator, in addition to their professional standing, is to have shared concerns and experiences with him at different times in his life and in his various fields of academic, institutional, domestic and international activity. The Conference comprises four sessions that turn on subjects which largely reflect the main areas in which he developed his body of academic work and his best economic policy contributions. The first session addresses monetary and fiscal policy; the second, the challenges of European integration; and the third and fourth, the Spanish economy and the role Ángel Rojo played in the design of Spain's economic policy.

Ángel Rojo's main achievement as Governor was his contribution to Spain joining the euro as a founding member. In this tribute to his memory, I would like to dedicate this opening address to sharing with you some reflections on the difficult and complex situation the euro area is now facing, on the economic policy lessons we should draw and on some of the measures adopted and those yet to be taken, all of which show that we are, I believe, learning something.

We are all mindful of the critical times European integration is facing; times so different from the first 10 years of the euro, in which the single currency provided all Member States with extra stability and defences against all types of shocks. Today we face a large-scale crisis, a situation in which we could well use the analytical quality and rigour of figures like Ángel Rojo to correctly gauge the economic policy measures needed to exit the crisis.

Various causes have led to this situation. But, if you will excuse my simplification, these may be grouped in two main blocks. On one hand, a lack of understanding by the Member States of the consequences of belonging to a monetary union, which translated into the adoption of national economic policies inconsistent with the framework adopted in 1999. On the other, a series of weaknesses in the European governance structure which have been progressively highlighted as the crisis has widened and deepened.

The diagnosis of the relative role played by national economic policies in the unfolding of the euro crisis is still subject to some controversy. But it would be reasonable to say that the lack of fiscal discipline has been a central factor, given the leading role the debt markets have played in the origin and transmission of tensions. As we learned, the fiscal discipline rules of the Stability and Growth Pact were insufficient to ensure the budgetary rigour needed for the normal functioning of a monetary union without fiscal union, and accorded governments an excessive degree of discretionality. Hence, there was a failure during the expansion years to adopt fiscal measures that would have provided greater room for manoeuvre to face the crisis.

The crisis also highlighted the interrelatedness which, at times of tension, arises between the three sides of the triangle comprised of sovereign risk, banking risk and the economic fragility stemming from the build-up of macroeconomic imbalances. Once one of these factors is activated, there is a serious danger feedback loops will be set in train that do but exacerbate and deepen the crisis. From this standpoint, the current strains are also attributable to the excessive complacency with which high levels of private debt were run up in several countries during the boom years and which, without the counterweight of sufficiently strict fiscal policies, ultimately led to a series of burgeoning current-account deficits.

The source of these imbalances is not unrelated to the asymmetries that prevailed in the opening years of the monetary union. Germany, the main economy in the area, was then in the throes of digesting the structural changes caused by reunification and by the wage-deflation policy underpinning its competitive adjustment. Along with some uncertainty over the sustainability of its welfare state, this prompted a loss of confidence that translated into notably sluggish expenditure. By contrast, in other economies in the area the reduction in funding costs and the favourable growth expectations generated in the wake of the euro fired euphoria, providing for a strong and lengthy expansion of demand and spending.

Swept along by the boom climate, much of the complacency that detracted from the importance of these trends gained ground. High levels of foreign debt were seen as a natural counterpart to the convergence process triggered following euro area entry. Attempts were made to prove that this benign interpretation was the correct one, drawing support from the fact that spending decisions were extremely easy to finance amid the exuberance prevailing not only on European but also global financial markets. Against this background, the enhanced financing possibilities provided by monetary union membership, owing to the disappearance of exchange-rate risk, allowed external imbalances to be financed without difficulty. Regrettably, we now know that capital inflows to these economies, far from funding investment projects likely to generate the returns in the future that would have enabled the loans to be comfortably repaid, were largely geared to financing spending components that have not sufficiently increased the recipient economies' productive potential.

The relative passivity shown by all economic agents in the face of the build-up of imbalances is also due to excess confidence in the adjustment mechanisms that were assumed to be inherent in the functioning of the euro. For instance, it was assumed that relative price and wage rises and the changes in competitive positions, induced by the demand and spending excesses in those countries showing signs of overheating, would prompt the necessary adjustments to move demand back onto a more sustainable path and to redress the differences in competitiveness.

We now have proof that the effectiveness of this adjustment channel depends on the flexibility of price- and wage-setting processes. Regrettably, virtually no progress was made during the expansion in eliminating the frictions and structural rigidities that distort the operation of labour and product markets in many countries. This lack of reforming ambition has inhibited the functioning of this adjustment channel, leading to the divergences in competitiveness not being promptly corrected.

It was also assumed that financial market discipline would contribute to correcting the imbalances since, on the basis of a proper risk assessment, those public and private borrowers that were accumulating excessive debts should have been penalised. But we know today that the first decade of the single monetary policy coincided with a period of excess liquidity and credit worldwide, widespread underestimation of risk and generalised laxity on the part of the regulatory authorities, who trusted financial markets and intermediaries to regulate themselves, which proved to be a very serious error. In this climate, the financial markets did not exert effective discipline on economies that ran up excessive debts, and whose borrowers benefited from risk premia similar to those enjoyed by other economies with more sustainable debt growth.

Yet neither the lack of economic policy responses, lax regulation nor the inoperativeness of the automatic adjustment mechanisms suffice to explain the virulence of the crisis, and much less so the systemic dimension it has acquired in recent months, in which the problems have spread to euro area countries with sound economic fundamentals.

At present everybody accepts that the slowness in resolving the crisis, and indeed the worsening of the crisis, is also due to the fact that the institutional arrangements for Economic and Monetary Union lacked suitable instruments to identify, prevent and, where necessary, force through the correction of the imbalances that might arise in the Member States' economies. Concern over the destabilising force of the fiscal imbalances within EMU led the Maastricht Treaty to envisage a formal budgetary discipline surveillance procedure, the Stability and Growth Pact, with ceilings or benchmark levels for budget deficits and public debt which, as we have seen, have proven absolutely insufficient. As to other economic policies, these were subject to even laxer oversight procedures, and proved worthless in redressing other imbalances.

The list of structural weaknesses in the area's governance framework would not be complete without mentioning the failure to design any crisis-management mechanism capable of making a rapid and forceful response in the initial stages of tensions, preventing the problems from becoming protracted and untreatable.

These shortcomings in the original design of Monetary Union have played an increasingly greater role as the crisis has advanced. Currently, investors have become fully aware of the particular fragility of the euro area countries' sovereign debt markets, which differentiates them substantially from the debt markets of other developed countries with their own currency and central bank. I refer, naturally, to the fact that the euro area combines a single central bank and single currency with 17 independent States and, therefore, 17 different sovereign risks.

Under these conditions, the well-known mechanisms that countries with monetary sovereignty have to counter potential liquidity problems on their national sovereign debt markets are blocked by the fact that the action needed would entail some transfer of income between States, action that the institutional arrangements of the euro area not only do not envisage, but which, it is assumed, must be avoided. This constraint paves the way for scenarios characterised potentially by self-fulfilling expectations and that lead to unfavourable outcomes in which funding suddenly dries up and the country affected may find itself bound to default on its debts, irrespective of the soundness of its economic fundamentals.

Euro area governments have spent almost two years trying to construct some mutual insurance mechanism that will perform a market-stabilising role, so far unsuccessfully.

While waiting for them to achieve this, a disproportionate part of the task of defending the stability of the euro area has fallen on the European Central Bank. Since the sovereign debt crisis broke, we have on the ECB Governing Council adopted numerous non-conventional measures to restore the workings of specific financial market segments – namely the money and public debt markets – that have proven crucial to bringing the operation of the monetary policy transmission mechanism back onto a more normal footing.

Early in the crisis the ECB adopted a generous liquidity-providing policy vis-à-vis financial institutions, implementing it over these years using far-reaching measures. For example, the change to a full-allotment system for all applications for liquid funds submitted by institutions; the extension of the assets eligible as collateral for these funds, precisely to prevent potential bottlenecks in this area that might ultimately make the full-allotment arrangement inoperative; and an extension of the maximum terms over which liquidity is granted, which in the recent December meeting was set at three years, a horizon that clearly goes beyond what, in normal times, should act as a reference for the pursuit of monetary policy.

The Securities Market Programme for the purchase of assets on secondary markets is also playing a significant role in restoring the normal functioning of the sovereign debt markets. That said, the ultimate causes of the tensions in place are due to underlying problems over whose resolution the monetary authority can exert little or no influence.

These policies respond to the need to ensure the correct functioning of the monetary policy transmission mechanism, without which the Eurosystem could not meet its objective of maintaining price stability in the euro area. But it should nonetheless be acknowledged that such conduct gives those responsible for the other areas of economic policy valuable time in which to pursue the design and implementation of the measures needed in those areas.

The ECB's conjunctural measures are of no use, however, in resolving the central problem revealed by the crisis: the need for mechanisms that help counter the risks arising from the fact that countries with heterogeneous structural features share a common currency and that, therefore, they can no longer resort to their own monetary and exchange rate policies as macroeconomic stabilisation instruments.

At the various summit meetings held in recent years, the euro area Heads of State or Government have reaffirmed their unequivocal political commitment to keeping the EMU project on track and to completing monetary union and moving towards greater economic integration. Evidently, though, in this process it will be necessary to share substantial sovereignty in sensitive areas such as fiscal policy or banking system oversight, and to set in train mechanisms allowing some degree of risk mutualisation, without this potentially discouraging economic discipline in the various countries.

The steps taken so far are along the right lines. But without wishing to speak out of turn, there is notable room for improvement in the pace at which decisions are being taken.

On the fiscal front, reforms to date have translated into a significant strengthening of the Stability and Growth Pact. Key factors in this reinforcement have been the greater attention to debt ceilings and the establishment of greater automaticity in the procedures to evaluate potential non-compliance and to activate the necessary corrective mechanisms, along with the requirement to revise national legal frameworks.

Elsewhere, the new framework for the prevention and correction of domestic and external macroeconomic imbalances has also been designed. This so-called Excessive Imbalance Procedure uses an early-warning mechanism based on a broad set of indicators which, together with timely economic analysis, should help detect sufficiently in advance those situations of vulnerability that may endanger financial stability in the euro area and give form to the measures needed to correct them.

Progress in designing a permanent crisis-management mechanism has been considerable but clearly insufficient. First, temporarily, the European Financial Stability Facility was introduced, and later, now on a permanent basis, the European Stability Mechanism was set up, which it is assumed should start operating next July. The complexities involved in the design of these devices are evident, since they must combine strength and flexibility to provide financial assistance to ailing countries, while ensuring that incentives are maintained to pursue the ambitious fiscal consolidation and structural reform programmes needed for laying the foundations for sustained growth in the medium term.

But exiting the crisis will not be possible unless a stronger European governance framework is accompanied by a far-reaching revision of national economic policies, enabling them to be fully adapted to the conditions under which a monetary union can operate. It is imperative that the authorities and economic agents should fully assume the consequences derived from sharing a single monetary policy. The soundness of public finances and the flexibility of economic structures are vital requirements in this framework.

Taking a shorter-term perspective, the need to lower the high levels of public and private debt accumulated in the past makes improving competitiveness the key to restoring confidence and the growth of output and employment. With no possibility of currency devaluation, internal devaluation, i.e. the adjustment of prices and remuneration, along with productivity gains stemming from better work management, is the only alternative available in the immediate future to promote and restore lost competitiveness.

Almost 12 years back, Ángel Rojo marked his departure from the Banco de España with his speech on the 1999 Annual Report. In a climate of exuberant optimism, he made a warning about credit growth which, he said, "continues to rise at very high rates", the result being "a heightening of demand pressure on trend output, with worrying effects". Our problems now are not excess demand or a surfeit of credit, but how to correct these "worrying effects" Rojo warned us about. Let me close my address with his recommendations, as I am sure they will be of interest to you:

"Under these conditions, the Spanish economy needs to restrain the expansion of demand and increase the degree of flexibility in labour and product markets in order to sustain high, stable growth rates in the future. Specifically, it requires a policy to further reinforce fiscal consolidation, to push through greater labour market flexibility in industrial relations bargaining and to forcefully pursue deregulation and the infusion of greater competition in product and service markets".

Thank you.