Miguel Fernández Ordóñez: Financial crises – impact and challenges for Spain

Opening speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the "XIX Encuentro del sector financiero", organised by Deloitte-ABC, Madrid, 10 April 2012.

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Good morning,

Four years have gone by since the Federal Reserve had to bail out Bear Stearns and what was then known as "turbulences" began, ultimately turning into the most serious crisis the developed countries have faced since the Great Depression in the 1930s.

A year earlier, Spain had begun to feel the effects of the exhaustion of a long phase of disproportionate expansion, in the form of a build-up of private debt and a loss of competitiveness. The latter, under way before Spain joined the euro, was fuelled by the low interest rates that suited the euro area as a whole, prompting an extraordinary deficit on the current-account balance.

The joint outbreak of these two crises, the international one and the domestic one in Spain, led output to fall and public revenue to collapse. And this, together with a further increase in public spending aimed at softening the recession, meant that the budget surplus run from 2005 to 2007 turned into a deficit in 2008 and came to exceed 11% of GDP in 2009. If this were not enough, in April 2010 a third crisis hit Spain: the sovereign debt crisis or the euro crisis.

Both the Spanish economy and its banking system suffered and continue to suffer from the coincidence of these three high-intensity crises, any of which may return at any time, since the economy moves in waves. But it appears highly unlikely that the conjunction of three such crises could recur for many years.

The challenges Spain had to face at the onset of the crisis were enormous. Public attention has focused on cutting the budget deficit, but the tasks of reducing the towering debt accumulated by households and firms, and that of regaining lost competitiveness within a monetary union are also huge. A Latin American colleague used a metaphor which, while exaggerated, clearly expressed the difficulty ahead of Spain: "regaining competitiveness", he said, "is like painting a house. If your brush is the exchange rate and it is flexible, you simply let it move from the top downwards. But since in Spain you're in the euro and you can't move the brush, all you can do is move the house upwards from below".

The task is an arduous one but not impossible if we believe that, though it is very difficult, we are capable of changing and reforming. This is why I shall begin my speech with an optimistic message, offering you some examples showing how Spain has already progressed with some adjustments and has undertaken major reforms during the difficult times we have faced during these years of crisis. I'm aware of the risk of showing optimism amid the crisis, in the same way that during the bubble whoever dared denounce the imbalances being built up was called a pessimist. But I hope my optimism is qualified by my reminder that complacency, that is to say believing that we have already done everything that has to be done and that nobody can teach us any lessons, is the arch-enemy in the battle to exit the crisis.

To earn the confidence provided by the knowledge that Spain has been capable of adjusting and reforming during these years of crisis, I have chosen two examples. First, the rapid improvement in our current-account balance; and second, the headway during these years in restructuring our banking system.

As is well known, under normal conditions the current-account balance is very easy to finance in a monetary union, but its size is a good indicator of two of the deepest imbalances that came about in Spain during the expansionary phase: the explosion in debt and the loss of competitiveness. Indeed, from 1996 credit began to outpace gross domestic product, doing so systematically until 2006, when its annual growth peaked: at a rate of over 25% for total credit, and more than 40% for credit extended to real estate development activities. Over the same period, Spanish CPI growth was systematically higher than that of the euro area.

Although the growth rate of credit began to fall as from 2006, growing debt and the loss of competitiveness over the 12 years to 2008 led the external imbalance to an unsustainable position, with a current-account deficit of 10% of GDP and a strong increase in Spain's external debt.

But what counts is that Spain has since adjusted its current-account deficit at a spectacular pace. From almost 10% in 2008, the deficit fell at the end of last year to 3.7% – an adjustment of more than 6 pp of GDP in three years – and at the end of 2012 we might already be in balance.

The climate of pessimism accompanying the crises leads some to underestimate the effort made by Spanish private-sector firms, suggesting that the external adjustment has been due exclusively to the fall in domestic demand. This decline naturally plays a part, but the improvement is also attributable to the relative gains in our export shares compared with other developed countries. During the years of crisis, Spain has seen its exports outgrow those of France, Italy and even Germany, and this situation should not worsen in the coming years.

And not only has there been an improvement in exports, but the decline in imports has been greater than the fall in domestic demand, which also shows gains in the share of sales of Spanish products at home.

Behind these improvements in the current-account balance is the significant progress recorded in the trade and services balance. Traditionally, Spain's trade balance with our European partners has run a deficit. Two years ago, this deficit had already fallen to €4 billion, but the good news is that at the end of last year it ran a surplus of a similar amount, meaning that, last year alone, there was a favourable turnaround of €8 billion in terms of Spain's trade balance with the countries of the Union. At a greater level of detail we can see how the non-energy goods balance improved from a deficit of €50 billion, i.e. 5% of GDP, in 2008 to a deficit of only €5 billion, i.e. 0.5% of GDP, at end-2011. And the balance of non-tourist services, which has traditionally run a deficit, moved into a surplus of €4.7 billion at end-2011 after posting a deficit of €2 billion in 2008.

A further example of the progress made during these difficult years has been the restructuring of our credit institutions. The Lehman Brothers crisis forced many countries to adopt numerous measures during 2009 to repair their banking systems. As is known, in Spain's case the direct effect of the international financial crisis – the sudden emergence of toxic assets on bank balance sheets – was minimal, thanks to the soundness of our regulation and supervision and to our banks' business model. But the indirect effects of the international crisis, such as the decline in GDP and the drying up of bank funding, seriously affected our system.

Undoubtedly, the most significant effect of the global crisis on our banks was the fact that the path of gradual adjustment of imbalances that Spain had undertaken and which until then was the scenario shared by all analysts and national and international organisations, suddenly turned into a collapse of all macroeconomic indicators. That obliged banks and savings banks to accelerate the clean-up of their balance sheets and to set in train what has ultimately become a full-fledged industrial restructuring of the Spanish banking system.

The toolkit at hand, which had been successfully used in the past, was not up to facing a crisis of this nature. The legislation on bank resolution had not been adapted to the demands of the Monetary Union, in particular to the prohibition of monetary financing, and nor did it envisage that it was savings banks that would essentially need to be repaired. Moreover, the singularity of a systemic crisis, on a global scale and with absolutely unrestricted capital movements, made it impossible to make creditors take haircuts without running the very serious risk that market alarm would ultimately lead healthy institutions to sink. Our main strength – one by no means insubstantial – was that the large credit institutions were reasonably sound and that the problems were concentrated in a clearly defined group of small and medium-sized institution.

So as to be able to have a new toolkit adapted to this crisis, more than half a dozen laws[1] had to be approved, from first creating the Fund for the Orderly Restructuring of the Banking Sector (FROB) in 2009 to the last Decree Law approved in February, with regulations that have set about righting the shortcomings. These include the creation of an institution/fund allowing for the obligatory and orderly restructuring of non-viable banks and encouraging the merger of viable ones; the regulation of institutional protection schemes; the possibility of converting savings banks into banks; new capital requirements to speed through restructuring; the granting of greater powers to the Banco de España; the merger of the deposit guarantee funds, etc. Promoting all these changes in a full-blown crisis was like carrying out two tasks on a ship that has hit the rocks: while evacuating the passengers, it was necessary to repair the lifeboats.

A most difficult task, as I said, but the seven laws have now been passed. And there is one very positive aspect, namely that all these regulations had the backing of the country's two main parties. This is perhaps why these reforms have maintained a series of common characteristics and, while giving due merit to the main actors, i.e. the different governments and the legislative chambers, mention might be made of the advice that the Banco de España has offered and continues to offer. The strategies pursued have involved using the least possible amount of public funds, concentrating on cleaning up bank balance sheets by demanding additional provisions, raising capital requirements, encouraging mergers, transforming savings banks and improving their governance, reducing capacity, increasing efficiency by bolstering the size of banks, making the worst managed banks disappear and minimising the time the State has a presence in banks in which it had to intervene.

The results mean we can be encouraged by what we see Spain has been able to do during these difficult years of crisis. As regards cleaning up bank balance sheets, since late 2007 to the end of last year provisions have been increased by €112 billion. Once this year, thanks to the recent legislation, an additional write-down of €35 billion is completed, a figure of €147 billion will have been reached, namely 14% of GDP. As regards capitalisation, deposit institutions have during this period increased their capital both in absolute terms and in relation to their assets, thanks partly to the fact that the legislation passed in 2011 and 2012 has imposed on Spanish banks capital requirements greater than those required by the Basel III calendar. As regards capacity, although the plans are not complete, there have been reductions of 12% in the number of branch offices and 10% in the number of staff, with sharper falls at savings banks (of the order of 16% and 13%, respectively). As to removing the weakest institutions from the system, 2 banks and 28 savings banks had disappeared up to December through integration processes, and there should be further processes in the coming months. Finally, as concerns having institutions on a more efficient scale, average size measured by managed assets has doubled over these years.

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[1] RDL 9/2009; Third Additional provision of Law 3/2009; RDL 6/2010; RDL 11/2010; RDL 2/2011; RDL 16/2011 y RDL 19/201; and RDL 2/2012

But perhaps the results best testifying to the transformation of Spain's banking system during the crisis are not quantitative but qualitative, for example, the metamorphosis of savings banks into banks. If before the crisis someone had said that, except for two small institutions, all Spanish savings banks would be converted into banks, nobody would have taken them seriously and they would have been accused of seeking to do away with one of Spain's oldest and best-loved institutions. Yet today what this conversion brings in terms of improved management, market discipline, etc. has been accepted, and should in the future spare Spaniards from again suffering the consequences of the excesses detected at certain savings banks. Another most important qualitative advance with a view to the medium term has been the enhanced transparency of our banks, not only thanks to the stress tests which, as you know, were first proposed by Spain, but above all to the greater disclosure requirements progressively imposed over recent years.

While the merit of what has been achieved should be accorded to many, allow me briefly to acknowledge the work of the staff of the Banco de España, and most specifically the body of bank examiners, economists, lawyers and the senior managers of the supervisory, regulatory and legal arms of the Bank, on whom the greatest burden has fallen in terms of implementing the strategy approved in legislation.

The fact is, the task discharged by them has perforce been complex and time-consuming. The decision by the authorities – previous and present alike – to use limited public funds in the reconstruction of the banking system was warranted because the big Spanish banks did not and do not need help and because, given the delicate situation of our country's public finances then and now, the impact on the markets of a sharp and sudden increase in the budget deficit might have led to the collapse or intervention of the entire Spanish economy, as indeed occurred in some other countries. But with this strategy of minimising the use of public resources, the restructuring work increases exponentially and extends over time. The Spanish supervisor has had no "bad bank" with which to restructure the sector. Here we have not seen a State which, armed with taxpayers' money, has bought bad assets from banks, thereby resolving all supervised banks' problems at a stroke.

Our Bank's supervisory team has had to apply a strategy which has obliged it to seek predominantly private solutions. And this takes considerably more time than addressing or doing away immediately with problems by injecting public funds. Yet this requirement to promote private solutions does not fully explain the enormous workload that has fallen on the supervisor over recent years. Insofar as it was decided at first to retain without major changes the singular legal arrangements for savings banks, and particularly their governance, this made it necessary to pursue most complex negotiations with the parties involved, namely trade unions, managers, regional governments, etc., each with very different interests from those that prevail in any mercantile company, where market discipline leads owners to worry about minimising losses and increasing shareholder value, and not about maintaining power, or the total amount devoted to early retirements, or about where headquarters should be established. In merger operations, processes such as determining shares of interest are reasonably easy to agree upon, since it suffices to make a proper valuation and to assign to each party what corresponds to it. But those who have followed the news in recent years will have witnessed the long drawn-out discussions, on a flimsy economic basis, that have been necessary to determine the power apportioned to each player in savings bank integrations. Before their transformation into banks, observance of the legal structure of savings banks meant that their restructuring could only move forward very gradually, step by step and with great prudence. The clearest example was the constitution of institutional protection schemes initially, without which it would have been extremely difficult to finally bring about inter-regional mergers.

Today some of these problems have already been resolved thanks to these seven laws that have gradually improved the resolution instruments available at the start of the crisis. For instance, with all savings banks having converted de facto into banks, the current situation differs greatly from that at the start of the process, when the regional governments had the power to veto mergers. And although the perseverance and skill of the Bank's supervisory arm managed to convince most regional governments of the inevitability of merging with savings banks from other territories, there have been cases in which sounder inter-regional alternatives were turned down for the sake of mergers which, though they were viable in the scenario then foreseen for the Spanish economy and avoided, moreover, more costly interventions for taxpayers, were clearly worse than the mergers suggested by the supervisor.

As encouraging examples of Spain's achievements during these years, I have chosen the progress made in correcting the current-account deficit and in financial restructuring. However, I could have chosen other actions. For instance, the Pension Reform Law has made historically significant changes and, if its sustainability provisions are properly implemented, will enable not only the pensions of our generation, but also of our children's, to be paid without problem. Spain has been one of the first European countries to have incorporated a balanced budget requirement into its constitution, with broad Parliamentary backing. A more recent example is labour-market reform. This is of great importance, because Spain had not taken such a significant step in this area since the 1984 reform. If the 1984 reform allowed Spain to create millions of jobs and to increase the welfare of Spaniards during upswings, the reform approved this year should put an end to a situation in which dismissal and an increase in unemployment are the only way of adjusting the economy. This reform leaves workers and employers free to agree to increase competitiveness by increasing productivity and/or adjusting wages, with the only obstacles or impediments being those laid down by law.

It is sometimes said that all this has been done too late. Should labour-market reform have been carried out five years ago? It certainly should have. Or ten years ago in 2002, when we were enjoying the long upswing? It would certainly have been better for Spain. The same can be said about financial reform. Why were savings banks not reformed during the good times? Why were bank resolution schemes, such as the FROB, not drawn up ready to resolve the banking problems created by the upswing? These questions merely lead to gloominess and, moreover, ignore the fact that, not only in Spain, but almost worldwide, key reforms are introduced at the worst times. More encouraging is the principle of better late than never, and the important thing is that Spain initiated the process of bank restructuring, now nearing completion, in 2009, that significant measures to reduce the budget deficit began to be adopted in May 2010 and that an ambitious labour-market reform was introduced in February this year. Spain has proven itself capable of making adjustments and reforms and this is essential to restore long-lasting upswings and sustainable growth.

But this reassurance must not lead to complacency. What we have done so far, despite its huge importance, is not sufficient. And some of us have the thankless task of pointing this out. For example, when each financial reform has been approved it has always been argued that the result will be more credit, but although bank restructuring is certainly an absolutely necessary condition, we have always seen that it is not sufficient by itself to make credit flow again. We have to restructure the financial system so that, as in any process of industrial adjustment, the resulting banks can generate a healthy profit and be sufficiently solid to meet demand when the adjustment process is complete. However, credit will not improve until solvent demand increases. Hence the importance of other economic reforms to boost consumer and investor confidence, such as reducing the budget deficit and reforms, such as the labour-market one, to increase the economy's growth potential. All these policies, and others which, for brevity's sake, I have not mentioned today, are essential to generate solvent credit demand and to ensure that a solid banking system can respond to such demand.

Having tried to raise your spirits, I must tell you that, despite the huge effort made so far, we are unlikely to see a prompt recovery in the Spanish economy. Emerging from crises caused by over-borrowing and competitiveness losses in a monetary union is a very slow process, and for that very reason we cannot afford to be complacent. The pace of the changes and reforms adopted by this country in recent years has to continue steadily.

What remains to be done in relation to the current-account balance and bank restructuring (to continue with the examples chosen)?

To improve the current-account balance Spain must continue to improve its competitiveness, in order to generate current-account surpluses for a number of years and so reduce its negative net international investment position. Moreover, this is urgent while the worst consequence of the euro crisis, i.e. financial market fragmentation, persists.

As regards bank restructuring, much has been done, but there still remains much to do, not only to continue to repair the effects on the banking system of an economic crisis that regrettably can still not be deemed to be over, but also to give us a framework for action to enable us to combat future crises. I am not going to talk today about what banks must do, which is a lot. I will merely give some examples of the tasks outstanding for the authorities.

With regard to cleaning up balance sheets and levels of capital, the latest reform has been a very important step, but nothing in life is final. If the Spanish economy eventually recovers, it will have been more than enough, but if the economy deteriorates by more than expected, then capital will have to continue to be increased and improved if banks are to remain solid.

Also, new instruments to increase credit to SMEs will have to continue to be tested. Some of these were discussed at a workshop held by the Banco de España in February in collaboration with the Spanish National Securities Market Commission (CNMV). At some point political decisions will need to be taken in this area.

Another area of work is to continue to reduce the size of savings bank governing bodies in order to avoid any duplication when they have transferred their financial business to banks they have set up, which must be stock-exchange listed when above a certain size. A more substantial alternative would be a law requiring savings banks to cease holding significant stakes in credit institutions, within a reasonable period, and to invest as they see fit, perhaps obtaining higher returns, in order to continue to pursue their welfare aims.

Yet while, as I have already said, much progress has been made in improving the resolution toolkit, the Banco de España needs to continue to be equipped with instruments to enable the performance of its supervisory tasks to be quick and simple rather than complicated and slow. For this purpose it would be desirable to transfer a significant part of the powers of the Ministry of Economic Affairs and Competitiveness in relation to sanctioning, licensing, etc., to the Banco de España, in line with what the IMF has been suggesting for some time. Also, the FROB needs to be authorised to assume the powers of the shareholders in general meeting in relation to banks taken under official administration and legal requirements that delay asset and liability transfers need to be eliminated. As for the Banco de España, it should equip itself with supervisory instruments to ensure that problems can be promptly corrected and it should distance itself from a legalistic system that envisages official administration only as the very last resort, when all legal requirements have been violated. Also, although the Banco de España's professional and collegiate decision-making structure – one of its valuable traditions – must be maintained, it needs to be documented further and made more systematic, and the information that has begun to be supplied on the Banco de España's website needs to be expanded.

More important still, however, is the need for the Banco de España's autonomy in the area of supervision to continue to be respected and for governments to continue to resist the temptation to interfere in its supervisory decisions, while continuing to design legal instruments and to defend the proper use of public resources. The Banco de España must continue to maintain a dialogue with governments, not only advising them but also listening to them (since nobody has a monopoly on good ideas), although supervisory decisions must continue to be based, as up until now, solely on a professional basis.

I have been emphasising today what has been done during these years of crisis by Spain (that is to say, everyone), because until our country has regained the trust of the rest of the world, the attention of investors will continue to be focused on what all relevant parties have done and are doing to correct the imbalances of the Spanish economy. In particular, they will be monitoring and assessing the extent of cooperative behaviour to overcome the crisis.

I'm going to conclude with a few words on Europe, as I believe our membership of the European Union and of the Monetary Union is another good reason for viewing optimistically our possibilities of overcoming the crisis. Some measures need no further explanation, as they clearly show how Europe has helped us and continues to help us during this crisis. A case in point is the decisions we have taken in Frankfurt since the start of the crisis, such as interest rate cuts, the unlimited supply of liquidity, purchases of bonds and covered bonds and three-year refinancing operations, which, while aimed at resolving problems of the euro area as a whole, have proven particularly beneficial for Spain.

But there are other less evident instances, such as when Europe obliges us to use competitive procedures to award banks that have been taken over or oversees the granting of public aid. Admittedly, this makes bank restructuring a lengthier and more complex process, but it should be acknowledged that it helps Spain ensure that sell-offs are open to all new investors that may be interested and that the taxpayer's money is better allocated.

The help of the European institutions should likewise be appreciated when, in compliance with the new economic governance framework, they obliged the Spanish authorities to be rigorous in cutting the budget deficit. This has not been to the liking of some but, however we view it, it is rightly one more reason to be confident about Spain's possibility of emerging from the crisis. The discipline required by Europe, which may prove uncomfortable and even debatable in the short term, has, like monetary discipline, extraordinarily positive effects on our economy in the medium term. It is as though Spaniards had taken out insurance so that our governments, authorities and companies cannot take decisions that harm Spain in the long run.

While we should be proud of our many achievements these years past, we must also be ready to listen to others, particularly and attentively so to the European institutions which, lest we forget, have been buying us time so that we can see through our adjustments. It is not the time for pessimism, but nor is it for complacency. What we must do is fruitfully use the time we have.

Thank you.