

## **Miguel Fernández Ordóñez: Economic forecasts, measures to exit the crisis, and the Spanish financial system**

Opening address by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, of the *Cinco Días* Series of Conferences, Madrid, 31 March 2009.

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Thank you very much for calling on me to inaugurate this series of conferences at a time burdened with challenges for economic analysis and economic policy.

Given the scope of this conference, I shall address three matters of interest to the media: economic forecasts, the measures needed to exit the crisis and the current situation of the Spanish financial system.

Economic forecasting has seen better days. Over the past 20 years, all institutions have been projecting high growth rates for the world economy in view of the benefits arising from increasingly integrated economic systems anchored firmly on free-market principles. Nobody could have conceived systemic market failings on a global scale such as those we are currently witnessing, and which are prompting a spectacular collapse in output and world trade.

And right now, in the thick of the crisis, it is still difficult to prepare macroeconomic projections. But it is precisely in these circumstances when we most need such projections which, while they may well contain a large margin of error, are of use to us for assessing the juncture at which economies stand. More than the specific figures in the projections, what matters most is knowing the direction and intensity of the forces driving current dynamics, so we may better identify and gauge the pressing measures needed.

The forecasts published by international institutions in recent weeks show that we face a severe global recession. Earlier this month, on 13 March, the International Monetary Fund published for the first time a negative growth rate for the world economy of between 0.5 and 1 pp for this year. A moderate recovery is estimated for 2010, but one still far below what we thought the growth potential trajectory was.

Unfortunately, for several months now, each new projection has habitually entailed a notable downward correction on the projection immediately preceding it. It would therefore not be unusual, once the IMF updates its world macroeconomic outlook in a few weeks, that the resulting forecasts should have worsened on those published this month.

The outlook for the euro area does not differ substantially from what the IMF anticipates for the developed economies. Early in the month the European Central Bank released what are still the latest projections for the area as a whole, placing growth at between -3.2% and -2.2% for the current year and between -0.7% and 0.7% for 2010.

As for Spain, next Friday, repeating an initiative first launched two years back, we shall publish our projections for 2009 and 2010. I shall leave the specific figures for Friday's release. But the projections of the Banco de España will simply confirm that the Spanish economy is immersed in a deep contraction, where the unemployment rate, if no measures are taken, will rise to a very worrying level and where practically the only positive features are the improvement in inflation and progress in the adjustment of the external sector.

It is clear today that the various adverse shocks - both real and financial - triggered by the international crisis impacted the Spanish economy when it was in the process of reabsorbing the imbalances it had built up during 15 years of high growth that had brought us progressively closer to the standards of the core EU countries.

These external and domestic contractionary forces, having unfortunately superimposed themselves, sharply accelerated the adjustment, turning it into a deep recession similar to

that affecting virtually all the developed economies. This recession, however, displays certain specific features in our country derived from the imbalances built up during the previous expansion and from the inadequacy of the measures adopted to strengthen our productive and market structures.

In Spain the contraction is affecting residential and real estate construction more severely. In these sectors excessive productive resources were concentrated and prices posted growth rates that were too high, taking them beyond levels consistent with their fundamentals.

The high debt incurred by Spanish households and firms, encouraged by overly accommodative financial conditions but also by optimistic expectations about future income, is now acting as a drag on their consumption and investment decisions. And further exacerbating this is the dizzying deterioration in confidence which, fuelled by the global climate of uncertainty, is pushing households and firms to postpone their spending plans and to strengthen their saving.

Pinpointing which specific mechanisms lie behind a certain type of behaviour of economic agents' confidence is always a complex task. But in the current circumstances, and especially in Spain, it would not be hazardous to link much of the behaviour of confidence to that of employment. The intensity with which employment is shrinking is the most distinctive feature of the recession in Spain. In this respect, it repeats traditional patterns of behaviour and shows the persistent weaknesses in the institutional structure of our labour markets that must be corrected.

The best way to restore confidence in these circumstances involves a calm and realistic analysis of the problems, reasoned discussion of potential solutions and the rapid implementation of measures deemed appropriate. When faced with a severe recession, neither an alarmist overstatement of the difficulties nor well-meaning calls for confidence in a prompt recovery that will come about spontaneously, with no need for relevant measures, are of any use. The only effective means for conveying confidence to agents, who clearly perceive the effects of the crisis, is through the acknowledgement of the actual impact of the crisis and of the challenges posed, together with a credible commitment to tackle resolutely and forcefully the reforms needed.

Before discussing specific measures, and given the difficulty of implementing them, we should question whether the Spanish economy might emerge from this crisis without undertaking reforms. The speed with which the Spanish economy is adjusting might lead us to think that the undoubtedly notable capacity of the Spanish private sector would alone suffice to swiftly reduce the imbalances built up over the past 15 years. Certain indicators, such as the spectacular improvement in inflation and the rapid reduction of the external deficit, might support this "comfortable" or "lazy" view that it would be possible to exit the crisis sidestepping painful reforms. Let me tell you what I think. Structural reforms are necessary and pressing, firstly to cut the cost of the adjustment, and secondly so that recovery is not unnecessarily delayed.

The real and financial crisis buffeting the world economy has deprived us of some of the attributes, such as readily available external financing and buoyant external demand, which in other circumstances might have helped us temper the intensity and speed of the adjustment of our domestic demand. It is precisely in the absence of such attributes that certain imbalances are being rapidly reabsorbed. In the last quarter of the year, there was a positive contribution of the external sector to annual GDP growth of more than 2 pp. In under two years, external financing requirements might have halved. Further, in December last year, the Spanish inflation rate stood at 1.5%, a substantially lower figure. And since then inflation has continued falling and the difference with the euro area countries, now in our favour, has improved to stand at 0.5 pp last month.

Nonetheless, such a rapid adjustment of the external deficit and of inflation, centred predominantly as it is on the contraction of demand, activity and employment, entails very high costs. In social terms, the ranks of the unemployed have swollen to around 3.5 million.

The productive structure is also being affected through the closure of numerous firms, just as the budgetary position is worsening notably under the pressure of more social benefit disbursements and the contractionary effects on revenue due to the fall-off in activity. Uncurbed, all these factors will bear heavily and adversely on our ability to overcome the crisis.

Accordingly, all tiers of government and social agents - central, regional and local government, Parliament and the regional assemblies, employers' associations, trade unions, institutions, etc. - should join forces in identifying the measures and action needed to resume as swiftly as possible a sustained growth path, and implement them with the utmost determination and diligence.

I would like to stress just two ideas which may help us understand the exceptional situation we face and justify the urgency of the measures Spain needs.

The first is that there is a feedback loop between the vicious circles in which the economy is caught and the contractionary forces at play. And if prompt action is not taken, these may inhibit the operation of the factors that should underpin a turnaround towards recovery. The second is that, once the worst of the crisis is behind us, i.e. when international financial markets regain stability and the world economy begins to pick up, the Spanish economy will not be able to resume growth at rates similar to those in the recent past if substantial structural changes are not addressed. This is because we will no longer be able, as previously, to resort to growing debt to stimulate domestic demand.

The fiscal drive to date had been notable. This is evident in the rapid deterioration in public finances in recent months. Accordingly, in order to infuse economic agents with confidence, a strategy should be designed immediately to allow a return to budgetary stability, which was of such benefit to Spain. The current priority, therefore, is to focus on applying forthwith structural measures to promote a growth pattern with a greater emphasis on productivity, in contrast to that followed in the past 15 years.

Specifically, among the aspects requiring the adoption of immediate measures are those relating to the workings of the labour market. The figures on falling employment and rising unemployment in Spain in recent quarters dramatically illustrate how our labour market accentuates the contraction in employment in downturns and acts as the main factor amplifying recessions. As you all know, this is Spain's most negative distinguishing feature relative to other advanced countries. Decidedly, we cannot put off adopting, as soon as possible, reforms to staunch the ongoing rate of dismissals and to promote to the full new hires.

It is vital to reform those labour market arrangements whereby the main means for the adjustment of Spanish firms continues to be labour shedding. Here, the current collective bargaining system plays a key role. As it stands, it prevents working and wage conditions from adjusting in a sufficiently differentiated manner to the different labour and productive environments that companies and productive sectors face.

The adverse effects of our particular collective bargaining system are not so visible in periods of strong growth, although then, too, they hamper increases in productivity. But in today's circumstances, where the crisis impacts companies and productive sectors very unevenly, such effects mean that the adjustment operates by unnecessarily forcing out a large number of workers from the market.

Therefore, at least during the crisis, collective bargaining agreements should be applied flexibly to allow employers and workers to reach temporary agreements within individual companies so that, in these exceptional circumstances, working conditions can be adjusted in exchange for maintaining employment levels or softening reductions. Recent days have seen some agreements along these lines. This option should become widespread, especially for those companies that have not participated in the negotiation of industry-wide or national agreements.

In addition to containing dismissals, these reforms should check the ongoing closure of firms. We should not lose sight of the fact that companies going to the wall entails sizeable decapitalisation costs. This is because it is companies that build up technological know-how and that have far-reaching knowledge of markets and of customer and supplier relationships. And this without prejudice to lifting administrative obstacles and thus ensuring that firms can be created swiftly and easily, so that when the recovery begins the momentum of demand translates into increases in activity and employment, and does not feed through to price rises.

To improve the labour market situation, there is also a pressing need to promote new hiring to the full so that workers who have lost their jobs promptly find a way back into employment, avoiding the prolonged periods of unemployment that had such adverse effects in the past. True, creating new jobs depends above all on companies' expectations improving in respect of the demand for their products. But current hiring arrangements fall short on a series of characteristics which, at times of uncertainty such as at present, have adverse effects on recruitment decisions. Exceptionally and at least during the crisis, then, consideration should be given to the possibility of introducing a simple and permanent employment-promoting contract, that can be used for all new hires and under an unemployment protection regime that does not discourage recruitment.

But the possible urgent measures I have outlined should not sideline either far-reaching reforms of our labour institutions or other major structural reforms that the Spanish economy needs. Indeed, the strength and sustainability of the recovery will largely hinge on the scope and rapid application of such reforms. Further, if they are tackled in sufficient depth, the excesses committed in the past decade will be avoided and the resources available may be assigned to more productive uses. Many proposals have been made in this connection, but I shall only mention those I consider important.

One aspect of paramount importance is the development of the rental market. And this is not only because it would notably increase the possibility of matching job supply and demand, but also because it would contribute to providing an outlet for unsold housing and to reducing rental costs in a setting in which housing may not be readily affordable. To do this it would be necessary, first, to ensure that the various measures adopted to improve legal security for owners are actually effective; and, further, to liberalise certain features of the current legislation, such as those relating to contract length.

Measures in the so-called network industries are likewise necessary. For Spanish firms producing final goods and services to be able to compete on an equal footing with other developed countries, it is crucial that those industries providing a large portion of the inputs these branches require should reduce their inefficiencies as far as possible. Among energy utilities, for instance, the degree of vertical and horizontal integration remains very high and interconnections with other countries are not advancing quickly enough.

In the telecommunications market, it is vital to step up competition in Internet access in order to reduce the related costs and spread its use. Turning to the transport sector, the National Competition Board has highlighted the presence of numerous restrictions to competition in the area of road haulage licences. In the railway sector a regulator has yet to be created, six years after Parliamentary legislation was passed to this end. Moreover, the boost to railway freight transport that access to new private operators would provide would also help us meet environmental commitments. Also, we must not delay any longer the development of a new airport management model.

And let us not forget to harness the magnificent opportunity the EU Services Directive has given us to do away with all national and regional obstacles persisting in the services industry and which are a drag on our growth. In this respect, the legislation recently approved by the Council of Ministers initiating transposition should smooth access to services activities; prior authorisation will no longer be needed, administrative procedures will be notably simplified and certain obstacles to free movement of services will be eliminated.

Nonetheless, the success of the reform, in terms of greater liberalisation of services, will depend on its proper application to key sectors, such as professional services and retail trade, and on the strict limitation of legally permitted opt-outs.

Top of the to-do list is a matter concerning the main source of wealth of any country: the human capital of its citizens. It is well known that the level of educational attainment of the Spanish labour force increased notably during the second half of the past century. But it is also a fact that convergence in educational terms with our European partners has slowed in recent years, which will bear most adversely on the economy's productivity. Many facets of our education system need changing, but the overriding priority is to extend and improve the quality of secondary education, an area where regional governments admittedly have an essential role to play.

The system for continuous training throughout employees' working lives must also work properly. Here, the delay in the labour market reform not only has adverse effects on employment but also discourages investment in human capital by workers themselves and by companies, which negatively impacts productivity.

Evidently, the situation we are in calls for a whole set of thoroughgoing reforms and measures, in step with the scale of the challenges facing the economy. And if the adoption of structural reforms always requires a particular effort on the part of the industries involved in economic, social and political terms in order to achieve the highest degree of consensus possible, such effort is evidently all the more necessary in the current exceptional circumstances.

Now on to the last matter I shall address today: the situation of the Spanish financial system.

The Spanish financial sector has been affected by the financial crisis since it began, although its effects have undoubtedly heightened since last summer. The current crisis has two characteristics. Firstly, it is an international crisis on a large and widespread scale, affecting different markets, numerous institutions in various countries, a wide variety of assets and the real economy. In a further manifestation of the process of globalisation, the problems generated in very specific geographical markets have ultimately spread to most countries, and it is not very realistic to believe that isolation from the crisis may be an option.

Secondly, the crisis is going to cause an across-the-board reduction in the financial and banking business in particular. The excesses seen in financial innovation and in overly expansionary credit policies have caused many of the current problems, whereby there will foreseeably be a back-to-basics movement entailing a clear reduction in total turnover in the financial sector.

These characteristics of the crisis shape the two principal challenges that financial systems face today: reviving the flow of credit to economic agents, and the orderly restructuring of the financial system. Let us analyse these two issues separately.

The first and most immediate aim is that credit and liquidity should once again flow unimpeded towards companies and consumers. The resolute action of European central banks and governments since October has meant that illiquidity strains have largely been resolved in the financial sector. However, credit to companies and consumers has been checked by banks' mistrust, by the increased risk profile of borrowers and by the sharp decline in demand resulting from the slowdown in economic activity. The deceleration is proving particularly acute and credit growth has fallen from a rate twice that of nominal GDP before the crisis to around 5%. And the prospect is that this trajectory will continue on the immediate horizon, with credit growth dipping to a zero or even negative rate.

That generates a perverse effect which feeds back into the difficulties of both those demanding and supplying financing, making a global approach necessary: just as it is inconceivable that the current difficulties of the financial sector may be resolved if the downward spiral of the Spanish economy is not curtailed, nor may it be assumed that the current situation can be plausibly overcome if the flow of credit were to seize up.

Nonetheless, the answer to restoring the flow of credit is neither publicly funded policies to purchase “troubled” (impaired or toxic) assets nor global and indiscriminate bank recapitalisation plans. While these measures have admittedly been adopted in many developed countries, they are not the most suitable measures for maintaining the flow of credit to the private sector, even if they have been of use in those countries that had to bail out systemic financial institutions. That does not mean they should be totally ruled out. But I am convinced they are of no use for resolving the problem of credit restrictions.

The credit-boosting measures best suited to the current situation of the Spanish economy are those aimed at improving the risk profile of both consumer and corporate transactions. This effect may be achieved through different means: e.g. loans subsidised by the Official Credit Institute, credit insurance or the deferral of social contributions. These measures, though not immediately effective and needing complementary action, will help gradually restore lending to companies and consumers.

A second challenge for the Spanish financial system is its orderly restructuring in the coming years. The soundness of our financial system, whose behaviour in terms of both solvency and profitability has been patently better since the onset of the crisis than in other developed countries, does not preclude the need for restructuring.

The changes in the financial environment (such as the narrowing of margins, external financing constraints or the increase in bad debts linked to the real estate sector and to unemployment) highlight certain core business weaknesses in part of the Spanish banking system. Some degree of restructuring to ensure the system's long-term resilience is therefore not only inevitable but also healthy.

Spanish systemic banks may ride out the crisis unaided. But clearly, as the case of Caja de Castilla la Mancha shows, if the international crisis is prolonged it might well prove necessary to restructure some small-and medium-sized institutions. And given the scale and intensity of the current global financial crisis, we should be ready to use more public funds than on previous occasions.

Parliament has just approved a widely backed motion incorporating certain restructuring principles that I find most interesting, and which I shall remind you of. First, the cost of bank restructuring should be as low as possible for the public coffers, whereby efforts should be chiefly directed at seeking solutions within the private sector. Second, the reorganisation plans chosen should not lead to a widespread recapitalisation of banks as a whole. And in relation to this, I would add two points: one, that the assistance - if any - granted to specific banks should be tied to their restructuring, since this is what the competition rules of the single European market require; and two, that the managers who pursued unsuitable business plans from the standpoint of prudent risk management should assume the consequences.

So as to maintain confidence in the Spanish financial system, all restructurings approved should fully observe bank creditors' rights. Finally, transparency requires that all reporting procedures deemed necessary be approved.

The ultimate aim of restructuring the Spanish banking system should be to improve the solvency of the resulting banks, the number of which will most likely diminish as a consequence of the decline in business volume over the coming years. This reduction in capacity will free up resources for other sectors with greater potential for economic development.

During the 1980s, Spain faced a most severe banking crisis that affected a significant proportion of the banks operating in that decade. That crisis, in conjunction with subsequent action, was a sufficiently valuable lesson on how to manage bank crises at the institution I preside over. Such experience should be harnessed for the restructuring still to be done.

Moreover, economic agents are aware that the decisions the Banco de España takes are, as our tradition demands, based solely on expert criteria geared to safeguarding banks'

creditors, preserving the stability of the financial system and upholding free-market principles. Using the Deposit Guarantee Funds, without prejudice to any additional instruments set in place, will secure the participation of the financial sector in this process.

Finally, I should not conclude without stressing that the degree of consensus social agents and political forces may reach will be the linchpin to ensuring the success of the restructuring process. It will be a difficult and complex process, and we should all ideally pull together for the benefit of the whole of the Spanish economy.

Thank you.