

## **Miguel Fernández Ordóñez: The real economy and the financial system – the importance of reforms**

Speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the meeting on the reform of the Spanish financial system, organised by Expansión and KPMG, Madrid, 23 February 2010.

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Firstly, I should like to thank Expansión for their kind invitation to speak today in this forum, where matters of great importance for the future of the Spanish economy and financial sector will be discussed.

The latest available figures suggest we are leaving the worst of the crisis behind. On the international front, despite some isolated bouts of tension, financial market behaviour continues to improve, the main developed economic areas have resumed positive growth and the pace of expansion in the emerging economies has stepped up. Against this background, and although doubts remain over the consistency of the recovery, the growth projections of the main analysts and international agencies have been revised upwards.

In Spain, too, the latest indicators suggest the sharpest phase of the decline in output is behind us. And, while with some delay compared with most of the developed economies, the outlook is for the start of a gradual growth phase during this year, based on a continuing positive contribution by external demand.

As I have said on previous occasions, the greatest cause for concern at present should not be predicting exactly when positive quarter-on-quarter growth will resume, but rather determining to what extent the Spanish economy is ready – or not – to move into a long phase of robust growth.

During the last upturn, the Spanish economy built up some significant imbalances, such as the excessive weight of real estate activities, a swollen external deficit, a relative loss of competitiveness, and high corporate and household debt. Over the course of the crisis, some of these imbalances have begun to be corrected, but others are still significantly holding back a pickup in growth.

With the crisis, these pre-existing structural problems have been compounded by an increase in unemployment to levels far higher than those of any other developed countries and by the sharp deterioration in public finances. These are now undoubtedly the two main problems affecting our economy.

To embark on a sustainable economic recovery, the imbalances built up by the Spanish economy before and during the crisis must be reversed. Job destruction must be halted and unemployment absorbed. And, further, an ambitious plan must be devised and set in place to cut the budget deficit, to redress the financial position of the private sector and, in sum, to mitigate all those structural shortcomings that are currently weighing on the recovery and contributing to reducing the growth potential with which our economy will face the new expansionary cycle.

To achieve these objectives, there has been insistence both in the Banco de España's reports and in my regular appearances before Parliament on the need to undertake wide-ranging reforms. The list is an extensive one and includes areas such as education, the knowledge economy, the liberalisation of goods and services markets, the boosting of competition in the network industries and the introduction of further improvements in the house rental market.

However, I would like to stress two reforms which I consider most pressing and necessary: budgetary consolidation policy and labour reform. The government has in recent weeks

tabled some proposals for reform which, in my view, are in the right direction. In respect of public finances, a cut of €50 billion in overall general government spending has been announced in the period up to 2013 and, within the framework of the so-called Toledo Pact, an increase in the retirement age has been proposed that would contribute significantly to the financial balance of the public pensions system.

The budgetary measures proposed are a significant public commitment by the government to fiscal consolidation. For that very reason, it is now essential that these commitments should be actually met, since otherwise Spain's credibility might be most adversely affected. As regards the labour market, the social agents have reached a wage agreement and the government has set out proposals for labour reform. Advantage should be taken of these initiatives to adopt specific and ambitious measures that entail deep-seated changes in the functioning of our labour market.

We stand at a pivotal juncture for our future, a point at which it is vital to radically change certain things so that Spain may continue to converge on the core European countries. Some of these reforms may require sacrifices, and it would therefore be best to have as broad a consensus as possible. The effective adoption of these reforms is crucial for the economy in general, but particularly so for the financial system. And if anything has been highlighted by the current global crisis, it is the close relationship between economic growth and the strength of the banking system. Two years on from the onset of the turmoil in summer 2007, most Spanish credit institutions continue to show considerable soundness. Unlike in many other countries, this has meant that practically no public aid has had to be used to bail out banks, which has prevented adding a further burden to the problems stemming from the recession. But the relationship between the economy and the financial system also works in the opposite direction and, evidently, if the necessary measures for reactivating employment growth within a reasonable time frame are not adopted, bad debts will continue to mount and there will be more financial institutions facing difficulty in providing the financing needed for economic recovery.

That our banking system has proven reasonably resilient during the international financial crisis is due to various factors. These include prudent regulation, more intensive supervision than that of other countries, a business model geared essentially to retail banking and sound management at most banks. But let me also stress – as it seems to me an example of what could be done now with the labour reform – that the government and the opposition, which has supported it in Parliament, have expeditiously agreed on a series of high-quality financial system reform measures that have proven most effective in preventing credit institutions' problems from bringing the country's economy to its knees.

We should not forget that if, for instance, the legislation on the funds for the acquisition of financial assets and on guarantees for bank and savings-bank bond issues had not been approved, we would no doubt have witnessed a shut-down of wholesale funding on global markets and an abrupt contraction in credit that would have led to a deep recessionary spiral. Fortunately, this did not occur.

That does not mean that credit standards are the same now as before the crisis. One of the most notable consequences has been the increase in risk aversion, which stood in the previous upturn at very low levels. This increased risk aversion translates into much stricter lending policies. As a result many companies, particularly small and medium-sized ones (for various reasons, such as the fact that they are not audited and are generally less capitalised than large companies), have seen their ability to obtain funding restricted, occasionally beyond what may be considered reasonable. The Official Credit Institute's programmes, aimed at smoothing small and medium-sized companies' access to credit, have attempted to correct this market failing. Further work along these lines should be pursued, improving where possible the workings of these programmes and increasing their volume if necessary.

Yet I must urge credit institutions to be responsible, as I have on previous occasions. Evidently, at a time such as the present, they must be particularly careful and, naturally, not

extend credit to companies that are not solvent; but nor must they forget that should they fail to lend but a single euro to companies that are solvent, they will only be making things difficult for themselves.

Another example of progress in financial reform backed by broad Parliamentary consensus has been the approval of legislation whose aim is to restructure the financial system at the least cost to taxpayers and in the shortest time possible, observing the constitutional distribution of powers, so that all institutions in the system are in a position to provide credit to households and firms when the recovery arrives.

So that ailing institutions may urgently embark on restructuring and integration processes or so that control may promptly be taken of institutions that are non-viable, Parliament – once again with the agreement of the party in government and of the main opposition party – has provided the Banco de España with the necessary instruments, namely the Fund for the Orderly Restructuring of Banks (FROB), for these processes to proceed normally and without risks to the stability of the system.

According to the law regulating it, the FROB may engage in two types of actions. The first involves pushing through and facilitating the restructuring of those banks that evidence pressing viability problems. In this type of situation, FROB regulations stipulate taking control of the institution and replacing its directors, by the FROB itself. The new directors shall draw up a report on the institution's situation, submitting a restructuring plan for the approval of the Banco de España. This plan shall include merger measures, spin-offs or, where appropriate, the winding-up of the institution, adhering to competition law and seeking at all times to minimise the potential cost of the measures for the public coffers. So far, this exceptional decision to take control and replace directors has only been unavoidable in one instance, prior to the approval of the FROB. If at any point it were necessary to adopt this decision at any other institution, rest assured that the Banco de España, thanks to the creation of the FROB, will act with all due diligence.

The FROB legislation not only provides the Banco de España with the necessary tools to act when there are serious problems of viability, but also provides for a second course of action, of a preemptive nature, geared to preventing these problems from materialising. With the approval of the FROB, institutions and their managers were urged to assess their own situation and to adopt the decisions needed to ensure their viability, preventing the more traumatic effects that might stem from supervisory intervention, both for the institution itself and for economic activity in the regions in which it pursues its business.

This second means by which the FROB may act involves supporting integration processes between institutions which, without being in serious danger, are seeking to improve their efficiency, streamline their management and re-scale their productive capacity. When the FROB undertakes such "pre-emptive" action, the Banco de España is entrusted with ensuring that the operations approved have a sound business plan that contributes to strengthening our financial system and that is accompanied by measures aimed at a realistic adjustment of bank resources to the new market conditions, using in this connection the smallest volume of public funds possible.

Unlike cases in which institutions are taken under control and their directors replaced, and where decision-making is entirely the prerogative of the Banco de España, authority to pursue this second course of action lies with credit institutions and, in the case of savings banks, authorisation by the regional government is also required.

In this pre-emptive phase, it is not the role of the Banco de España to decide which integration processes should go ahead, but to examine rigorously the proposals received. In its capacity as the supervisor of banking system solvency, the Banco de España has been entrusted by the legislature with evaluating, on the basis of strictly professional criteria and irrespective of any other personal or collective interests, whether the plans submitted offer sufficient guarantees of soundness and viability.

Allow me to convey to you my assessment of how the integration processes under way are progressing under the application of the “pre-emptive” measures of the FROB. First, I view most favourably the fact that, shortly after the approval of the FROB, a sizeable number of savings banks set about working to seek solutions based on mergers and restructuring. But it is also clear that some of these processes are being delayed longer than would be desirable. I must therefore call once again for responsibility on the part of those banks that have incurred the biggest delays: they should examine their situation realistically and consider forthwith viability strategies in the search for solutions conducive to creating stronger institutions that are better able to provide households and firms with the credit flows they demand. I likewise call on the sense of responsibility of certain regional governments and urge them to ensure there are no further delays or obstacles to processes that may strengthen the institutions operating in their regions.

The progress brought about by this series of reforms approved with broad Parliamentary consensus does not mean that our financial sector does not face significant challenges ahead. During the last upturn households and firms rapidly incurred debt, a process matched by exceptionally high credit growth rates. This setting was conducive to an increase in the size of the banking sector, to the point of reaching a dimension which now, with a much less favourable outlook, will hardly be sustainable.

The lower growth in demand compared with the previous stage, combined with the process of corporate and household deleveraging, will entail a fall in the volume of activity. To this can be added various factors which in the near future will act to squeeze unit margins, such as low interest rates, increased bad debts, higher capital requirements for both regulatory and market-related reasons, tighter financing conditions (risk premia are higher than before the crisis) and the increased importance of doubtful asset management.

The management of doubtful assets in the real estate sector will be particularly important. In this respect, allow me some brief thoughts on the supervisory activity of the Banco de España. In the last few weeks some opinions have been aired on the lack of transparency of the Spanish banking system, as a consequence of a failure to duly record the excessive concentration of risk in the real estate sector, particularly that in property development companies.

Obviously both the banking sector and the Spanish economy have to digest the excesses of the real estate cycle, which has proved to be unsustainable. However, in assessing the position of the banking sector, the exposure to a sector and the complexities associated with the crisis in that sector should not be confused with potential losses for banks. For an exposure to become a loss involves there being a default and, insofar as the exposures to this sector are secured by collateral, the ineffectiveness of that collateral in compensating for the default and the non-recovery of the loans in question.

Furthermore, unlike what generally happens in other countries where the loss estimates used to calculate provisions are made by auditors, here the Banco de España has established an objective system for calculating provisions which reduces downside discretionality. Also, the Banco de España has obliged banks to adopt pre-emptive measures in the form of a larger pool of provisions. These can be used to cope with possible impairment of their real estate assets by, for example, raising the provisions to be made from 10% to 20% of the value of the properties held on their balance sheet when these assets remain in their ownership for more than 12 months, as a precaution against sale at a lower-than-expected value.

In any event, we face an extremely complex scenario and it is essential that all Spanish credit institutions, particularly those that have taken most risk, prepare themselves and adopt the measures needed to ensure their profitability. For this purpose, they will have to undertake the downsizing of the sector and, at the same time, push through measures to raise efficiency through cost containment and through the introduction of improvements in their risk control and management mechanisms and of ongoing innovation in product marketing and in the implementation of technological and organisational improvements. And

the government could crown the significant financial reforms made so far with one directed at savings banks. I am thinking of the reform needed so they can raise high-quality equity funds that enable them to grow and continue serving Spanish society while complying with the requirements to which they will be subject in the new international regulatory environment in the coming years.

The financial system reforms adopted to date might suffice for the Spanish banking system to get through the crisis and be in a position to extend credit to those needing it in the recovery phase. But this will only happen if the reactivation of the Spanish economy comes in a form that substantially reduces the number of unemployed, improves its competitiveness and increases productivity. If this does not happen, obviously the restructuring task that we would have would be much greater than that facing us at present. Thanks to the reforms adopted, the Spanish banking system has not been an additional problem during the crisis. But if the economy does not improve substantially due to the lack of sufficient consensus to undertake structural reforms, credit institutions will end up being damaged and will be unable to help in the recovery.

For this reason I wish to devote the last part of my address to the economy and, in particular, to the other major reform required before we can start a new phase of sustained growth: labour reform. This reform is necessary not only for the obvious reason: the need to reduce substantially the disproportionate unemployment figures beleaguering the economy and Spanish society. It is also necessary, as I have said earlier, so that the rising bad debts and wholesale funding difficulties do not oblige the banking system to reduce credit more than it will already be cut by the cyclical downturn. The labour reform is also essential so that the ambitious budget consolidation programme proposed by the government can be successfully carried out. If there is no labour reform and the bloated unemployment figures persist, public finances will suffer in two ways: not only regarding expenditure, which has already reached enormous proportions, but also on the revenue side, because the millions of people who remain jobless barely contribute to public revenue.

The labour reform is also vital for GDP growth, for two reasons. First, because flexibility in agreeing wages and other aspects of firms' internal organisation is indispensable for improving competitiveness in a monetary union where devaluation is no longer an option. If, on a firm-by-firm basis, workers and managers decide to adjust their conditions to the changes in demand, the highest possible number of firms and jobs can be preserved. Furthermore, by improving productivity in those firms which will perceive the favourable change in the economic environment, the labour reform would enable workers' wages to be improved and thus increase domestic demand without impairing the competitiveness of the economy.

The list of necessary reforms in Spanish labour institutions is very long. But two of them are vital in order to judge the extent of the reform finally undertaken. The one to which most media attention is devoted is the issue of a permanent employment contract that does not deter those businesses which wish to create jobs. Although hiring is important, at this point in time I feel that it is particularly urgent to address the change which has to be made in collective bargaining. At this juncture it is of paramount importance that the trade unions and employers' associations – which in complicated situations in the past have made telling contributions to the Spanish economy – should now let the workers and entrepreneurs of Spanish firms decide how they can best save their businesses, preserve their jobs and even expand their workforce. Quite another thing is that they may give guidelines or advice to firms in the negotiation of wages and other working conditions. But it is vital that, at least in the next two or three years, firms and workers are given the freedom and the opportunity to, in some cases, save their business, and, in others, to achieve the increases in competitiveness and productivity which current collective bargaining arrangements preclude.

This reform is particularly important in a setting where there is a need to change our country's pattern of production. The so-called productive model is ultimately the result of the

structural and institutional features of each economy. Spain has a model which is inseparable from its current institutions and, if we wish to move towards a situation in which the most productive sectors play a leading role, we have to change the current labour framework to provide for and promote the reallocation of economic and human resources towards the sectors best endowed to add the most value. The required sectoral redistribution of labour is unlikely to take place if region- and industry-wide collective bargaining agreements continue to prevent each firm's wages from being linked more closely to productivity.

With the labour reform, Spaniards should adopt the same attitude shown by other countries in the reform of their financial system. Those countries which had serious problems with their banks have acknowledged their failure and have set to work to reform regulations that failed. They are thus examining what has been done in other countries, including Spain, so that those banking problems do not return. Together with the Secretary of State for Economic Affairs, I am participating in Financial Security Board (FSB) discussions to radically reform the financial systems of all countries. Both of us have had the privilege to witness how Spanish banking regulation and supervision is being carefully appraised and, insofar as is possible, it is intended to take advantage of the good work done in the past in Spain.

We in Spain should take this same attitude to learning. We should recognise that we have failed in labour regulation since, for the third time in recent decades, unemployment has approached the unacceptable figure of 20%. We should therefore find out what other countries are doing with their labour institutions and try to incorporate into Spanish legislation whatever seems most reasonable to achieve their low unemployment rates and their high labour productivity levels.

Unfortunately, we are at a historic crossroads. If we do not undertake ambitious labour reform, the Spanish economy will enter a tough and complicated period, in which not only will growth be lower than it would be with extensive reform, but, moreover, its impact on public finances will be extremely negative, making it difficult to achieve the targets set in the Stability Plan. The same can be said of the banking system, since if we undertake sufficiently extensive reform, we will be able to reasonably negotiate the current crisis; otherwise, banks would have to ultimately focus on the battle against bad debts and on the difficulties in obtaining external funding, and the authorities would have to focus on restructuring the banks that have deteriorated to the point of being clearly inviable.

However, if we take advantage of this historic moment and carry out far-reaching labour reform, we will face a more positive scenario in which Spanish firms could promptly raise their competitiveness in the difficult (for these purposes) environment of a monetary union. Spain would enter a scenario in which increased productivity would provide a significant boost to its best firms. This would be particularly positive for SMEs, which find it most difficult to take advantage of the flexibility mechanisms offered by the current institutional framework, and they would benefit enormously from the implementation of a more flexible and simpler system. Meanwhile, budgetary consolidation could be achieved without swingeing cuts in expenditure and the banking system would be in a position to support this new growth phase.

It would thus be a mistake to opt for small-scale labour reform, as if we could even afford to tackle this reform slowly, in various phases over various years. This would have been possible 5 or 10 or 15 years ago, when the last expansion phase started and the need for labour reform was not pressing. Indeed, there was so little urgency that, unfortunately, in the last 15 years there has not been a single labour reform capable of preventing our rigid labour markets from suffering, for the third time, an adjustment along the old familiar lines of leaving millions of Spanish workers jobless.

Voices are sometimes heard casting doubt on whether labour reform is urgent, arguing that the labour market is not at the root of this crisis. This is quite true, but it is an argument which does not constitute grounds for ignoring the prime importance of this reform. If you allow me the metaphor, our labour market has shown itself to be a fragile ship which, each time there

is a storm, springs leaks which are enormously costly to seal. Obviously the storm is not the fault of the ship's captain, but he can make repairs before it is sunk by the storm. But, what is more, our labour ship also functions poorly when there are no storms. In the periods of highest growth of the world economy, we continue to have the highest unemployment rate and our labour productivity growth is mediocre, limiting the scope for wage increases. The ship does not sink but it sails – in terms of productivity and of reducing unemployment – at a poor speed in comparison with the rest.

Lastly, it is true that, even if a reform is approved which assimilates our labour institutions to those in the more developed countries, this does not ensure the immediate resolution of our problems of growth, public finances or banking system health. More measures have to be adopted and, among them, as I have said, budgetary consolidation is key. But let there be no mistake: while labour reform is not a sufficient condition, it is nevertheless an absolutely necessary and essential one without which the other measures or reforms adopted will have a much diminished effect on the competitiveness of our economy.

Thank you.