Miguel Fernández Ordóñez: Pressing tasks needed to improve Spain's economy

Address by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the "XXVII Reunión del Círculo de Economía", Sitges, 3 June 2011.

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Good morning.

Let me first thank the Círculo de Economía for kindly inviting me to participate in this forum.

Had you invited me in March last year to talk about the foundations for a new economy in the 21st century, I would surely have focused on what I see as the main challenges facing us this century. Firstly, population ageing, which will affect not only the developed countries but also other emerging nations such as China. Secondly, the growing inequality that has appeared in some countries along with the positive effects of globalisation. Thirdly, the pressing need to use natural resources – and energy resources in particular – rationally. And finally, I would have taken the opportunity to discuss the changes under way worldwide in financial regulation to avoid a repetition of the crisis we have experienced.

But I'm not going to talk about this, as in April last year the Greek sovereign debt crisis broke and, since then, the euro area has been immersed in a crisis still to be resolved and which might have very serious consequences not only for its members but for all Europeans and for the world economy as a whole. If this crisis is not suitably resolved, the effects on the global economy and financial markets might be most significant not only due to the strong links connecting the main economies, but also because the doubts over the sustainability of public finances might ultimately pass through to other major developed economies.

The euro area is the epicentre of a crisis whose resolution is key to what may happen in the European and global economies in the opening decades of the 21st century, and it is on this that I shall focus today. European integration can only move forward if the euro area economy operates once again without upheavals. And since European integration is fundamental to the well-being of all Europeans and, naturally, of Spaniards, Spain must, like the other countries and the European institutions, make every effort to resolve the crisis.

The truth is, as the Governor of the Bank of France said last week, if we don't resolve this crisis properly, a "horror scenario" might ensue. But I'll resist the temptation of detailing all the adverse consequences that failure to overcome this crisis would have for European citizens. To quote Fernando Pessoa, "to be a pessimist is to see everything tragically, an attitude that's both excessive and uncomfortable". Therefore I'm going to take a realistic but optimistic approach, stressing the steps forward we have taken to date and presaging a happy ending for this crisis if the necessary measures are adopted.

All the EU Member States have a responsibility to resolve the crisis. On one hand are the governments of the countries that show the biggest divergences, and whose conduct is key to exiting the crisis. And on the other are the governments of the countries which, given their importance in the area, are central to euro area and EU decision-making, since overcoming the crisis will only be possible if the European institutions' complex decision-making process works well.

But we will better understand what each of these players must do to emerge from the crisis if we reflect firstly on the mistakes they have made over the 11 years that a monetary union has been in place without a political union.

Let's begin on that point. You will all recall that when the euro was created, many academics, especially from Anglo-Saxon circles, warned that the monetary union was doomed to fail, since it did not meet the essential conditions of what is known as an "optimal currency area".

Among other aspects, it was stated that a monetary union could hardly be successful if there were no fiscal transfer mechanism allowing asymmetrical shocks affecting a specific part of the monetary union to be accommodated. In this connection, critics of the euro project said – and still say – that a monetary union should not be maintained if there is no political union. They argued that the potential divergences between different areas could only be offset or resolved if there were a single budget for the entire area. Otherwise, a durable single currency would not be feasible.

Yet given that political union in Europe over the short term is inconceivable, will a monetary union not be able to survive without political union? In my view, the most important lesson we've learned in this crisis is that it is possible to enjoy the benefits of a single currency without political union, but only if strong divergences between the member countries are avoided.

This has been understood by the European Union and is what has prompted the changes to the Stability and Growth Pact and to economic governance, which are intended precisely to correct divergences before they become so great that they are difficult to redress. And it must be acknowledged that here a good deal of progress has been made over the past year.

The unfolding of the crisis has shown that the governance model in place to date in the EU has been of no use in ensuring economic policy consistency or in managing crisis episodes flexibly and effectively. It's now clear that public finances were not sufficiently restructured in the upturn, that macroeconomic divergences were excessive and that we need a well-designed financial aid mechanism to assist ailing countries swiftly and effectively.

Mindful of this, European governments and institutions have taken major steps towards correcting deficiencies in three fundamental areas: the strengthening of fiscal discipline, closer surveillance of macroeconomic maladjustments and the creation of a permanent crisis-management framework.

Starting with fiscal discipline, public debt levels will be more closely monitored and countries will have better incentives to comply with their commitments, through the introduction of broader and transparent sanctioning arrangements, which will moreover be applied at an earlier stage and, as far as possible, automatically. Further, the reform of national fiscal frameworks is being promoted, so that budgetary policy rules and surveillance systems will be adopted that help curtail spending.

Moreover, a new framework for the prevention and correction of macroeconomic imbalances is being established. The aim of this mechanism is the early identification of the emergence of potentially "excessive imbalances". When imbalances are considered to be too big, an excessive imbalance procedure will be initiated which will include recommendations for the adoption of corrective measures.

The third key element of EU economic governance reform is the creation of a permanent crisis-management instrument, the so-called European Stability Mechanism, which will come into force in mid-2013. Geared to lend up to €500 billion, this mechanism will provide funds to countries with liquidity problems under strict conditionality.

Finally, a mention for the Euro Plus Pact, approved in March by the euro area Heads of State and of Government. This pact involves a commitment at the highest political level to adopt the measures needed to attain competitiveness and employment-promoting objectives, to contribute to the sustainability of public finances and to reinforce financial stability.

There's always room for improvement and, at the ECB, we have called on Heads of State to strengthen governance procedures further, for instance by making sanctions more automatic in cases of non-compliance so as to prevent governments succumbing to the temptation of being excessively lax. This was seen in 2005 when the core countries failed to meet their deficit commitments and the Commission and the European Council agreed to change the rules so as not to sanction these countries. But the lesson whereby maintaining a monetary union is only possible if divergences remain within a moderate range must also be taken into account by the national governments of each of the euro Member States, because the policies that may prevent the emergence of these imbalances or help to correct them are, for the most part, the responsibility of national governments.

Many tasks lie ahead for all the euro area countries in contributing to reducing divergences. But it is our duty to pay more attention to what Spain should do. Our country reacted a year back when the sovereign debt crisis broke, and it showed resolve in adopting far-reaching measures to correct our economy's imbalances without resorting to aid from its fellow members. It was able to do so, firstly, because its divergences were not overall as great as those of the countries that have had to apply for external financial assistance. And secondly, because the Spanish parliament was prepared to approve some of the harshest and most difficult measures adopted in Europe to rapidly reduce the budget deficit.

But the task is by no means complete and, therefore, the responsibility of Spain's parliamentary forces remains of paramount importance. True, the countries that required financial assistance have more problems to resolve, but in their favour they have precise programmes of measures agreed with the International Monetary Fund and the European Union with which they must unfailingly comply. If they fail to do so, they will be withdrawn. They know perfectly well what they have to do and when they have to do it. In our case the responsibility is greater, since we ourselves must decide on the content and timeframe of the reforms and that means we must be capable of adopting the right measures for exactly as long and as intensely as required, and over a sufficiently short timescale so as to convey to all the firmness of our resolve to overcome the crisis.

Let us turn to the most important and pressing tasks facing us: to bring about far-reaching change in the legal and institutional framework for employment, to comply with the deficit-cutting plan and to complete the restructuring of the financial system and the overhaul of savings banks.

Nothing is more necessary for improving the well-being of workers and of all Spanish citizens than reducing the unemployment rate and raising productivity so that wages may grow at a higher rate. But this task has also become a pressing one since, as euro area membership precludes using the devaluation tool, reform of the employment institutional framework is vital for increasing productivity, and thus for restoring competitiveness and raising our growth rate.

Lately, those convinced of the importance of this reform have grown in number. But among those showing reluctance, a new argument has now arisen which seeks to play down the need for reform because, they say, it will take time to bear fruit. I have two counter-arguments here. First, Spain has moved so far away from the various employment institutional framework models in the developed countries that a rapid approximation to them could have more immediate effects than in other countries. Admittedly, a reform of this type would not swiftly lower our unemployment rate to the average European level, which is below 10%; but a reduction in the unemployment rate, no matter how modest at first, would have most favourable consequences for domestic and external confidence in the Spanish economy. What's more, even if it is thought that results will only emerge gradually, slowness in taking effect is no argument for delaying this reform a minute longer; rather, it is an excellent reason to adopt it immediately so as to be able to enjoy its effects as soon as possible.

Regarding fiscal consolidation, there is little to say and much to do. Little to say because the government-approved Stability Programme, which envisages quickly attaining a significant deficit cut, has been favourably assessed by the EU and strictly met in its first year. The now-difficult task is for all levels of government to rigorously meet their adjustment commitments this year and to enable the 6% overall general government deficit target to be attained. Henceforth, we should expect local and regional authorities not to put off any longer the vigorous expenditure-cutting decisions that are needed to meet this overall target.

Finally, concerning the restructuring of savings banks, the final part of what was legislated by Parliament in the recapitalisation Decree-Law approved in February remains to be done, but so far the Decree-Law has been implemented under the conditions and within the timeframe set.

On 11 March the Banco de España published the core capital requirements of all Spanish credit institutions. Among them, 12 (4 banks and 8 savings banks) were identified as having a core capital deficit for a maximum amount of €15.15 billion. Later, when one of the integration projects came unstuck, the number of institutions needing additional capital rose to 13.

On 14 April, the Banco de España approved the strategies and timetables submitted by these 13 institutions or groups. Two were subsidiaries of foreign banks, which have been recapitalised by their respective parents; the two Spanish banks have reinforced their capital by resorting to the markets; four savings bank groups have considered an initial public offering or the raising of capital from investors as a priority option, with a subsidiary alternative of resorting to the FROB (Fund for the Orderly Restructuring of the Banking Sector) if their initial approach did not work out as planned; another savings bank has stated its preference to participate in an integration process with another more capitalised institution; and, lastly, the remaining four savings banks have expressed their preference to reach the required level of capitalisation by means of the FROB taking a stake in their capital.

Before 28 April, those institutions that had considered going to the FROB as a priority source submitted their specific recapitalisation plans to the Banco de España. In the meantime, the FROB has formally undertaken, with all institutions that have submitted strategies envisaging the possibility of resorting to it, to provide the necessary funds so that all institutions in the Spanish banking system may comply with the new core capital ratio.

At present, the recapitalisation plans submitted by the institutions are being analysed, as a further step in the timetable. By 30 September 2011, these institutions must have completed what was stipulated in their strategies. This deadline may, as provided for in the Decree-Law, be extended by three months by the Banco de España if considered necessary for justifiable operational reasons, and by up to six months if an initial public offering is involved.

A conclusive step will thus have been taken in the savings banks sector restructuring strategy, which has entailed unprecedented change on many levels: balance-sheet write-downs at institutions; integration projects among savings banks to achieve bigger and more efficient institutions; a change in corporate model to smooth access to capital and to encourage enhanced governance, and, lastly, the recapitalisation of the sector. If these three reforms are resolutely seen through, there will be a favourable change on the markets similar to that seen in the first half of this year when the pensions reform and the recapitalisation of credit institutions were approved. Spain might feature next year as a euro area country that still has a high deficit – 6% at end-2011 – but comparable to that of other major euro area countries and with the lowest debt level among the biggest economies in the area. Moreover, once the restructuring and recapitalisation of the banking system has been completed, it will be more apparent that all credit institutions have a high degree of capitalisation and that only a small portion of the sector has required public aid. Finally, if a sufficiently far-reaching reform of the employment institutional framework is undertaken as to turn employment around, confidence will be restored in the capacity of our country to generate robust growth once again.

The favourable assessment of these reforms along with the progressive improvement in economic figures as a result of headway in the adjustment of the imbalances (the reduction in net borrowing, the resumption of moderate inflation, the adjustment of the real estate sector, the lessening of the negative contribution of the construction sector to GDP growth, etc.) will prompt a positive change in the perception of the Spanish economy and in domestic and foreign investors' confidence. That would lower the risk premium of the Kingdom of

Spain, providing for better financing conditions for our companies and for the public sector, and giving an additional boost to growth which has in fact ceased in the first quarter of this year to bring up the rear among the major euro area countries.

To conclude, I have focused today on discussing the most important and pressing tasks needed to improve our economy. Evidently, though, there are many more that will take time, not least of which is doing everything possible to raise the level of educational attainment of our labour force. What I am certain of is that it would suffice to comply satisfactorily with the three tasks I have set out in order to bring about a change in perception by the domestic and foreign agents that fund us, and that this would be the best contribution Spain can make to resolving the euro crisis. Experience has shown that Europe has learned and even emerged stronger from crises. If the other countries and European institutions fulfill their tasks, this crisis will have ceased to be a determining factor of the course of the European and world economy in the 21st century. And we may then move on to talking more calmly about ageing, inequality and the rational use of national resources, matters which I view as essential for understanding what is going to happen in the world economy this century.

Thank you very much.