

"THE SPANISH ECONOMY AFTER THE CRISIS". OPENING ADDRESS BY THE GOVERNOR OF THE BANCO DE ESPAÑA, MIGUEL FERNANDEZ ORDOÑEZ, AT THE "IV CONFERENCE ON THE UNIQUE FEATURES OF SPANISH SAVINGS BANKS" / FEDERACIÓN DE USUARIOS DE LAS CAJAS DE AHORROS (FEDERATION OF SAVINGS BANKS CUSTOMERS)

**“The Spanish economy after the crisis”. Opening address by the Governor of the Banco de España, Miguel Fernández Ordoñez, at the “IV Conference on the unique features of Spanish savings banks” / Federación de Usuarios de las Cajas de Ahorros (Federation of Savings Banks Customers)**

Thank you Mr Chairman,

The profound worldwide economic slowdown, which in the industrialised countries has already turned into a rapid and sharp recession, is undoubtedly the most serious since the 1929 Great Depression. In recent months, the collapse of international financial markets has been averted only with great difficulty and we don't yet know what the final consequences of the events unfolding will be for the real economy.

Faced with this situation, all efforts will inevitably focus on attempting to exit the crisis. Internationally, and within Spain, hitherto inconceivable measures have been adopted, such as unlimited liquidity injections by central banks, extensive fiscal stimuli and exceptional support to the financial system. Naturally enough, governments, politicians, central bankers, supervisors and academics are all contributing to these tasks. And it is not surprising, therefore, that all my speeches in recent months have been to analyse the causes of the global crisis and to review the various measures to tackle it.

However, on receiving your much appreciated invitation, I thought I'd take advantage of the sense of calm reflection which university fora instil to pause and ponder on what may happen to the Spanish economy after the crisis, when the global economy recovers.

It is worth reflecting on the aftermath because the global nature of the crisis is “homogenising” the different economies. And by blurring the differences from one economy to another, it is hard to discern the different tasks awaiting them. As the crisis left nobody unscathed, not even those countries which acted prudently, i.e. those that did not incur excessive debt or whose competitiveness did not worsen, are faring better than those which were not so virtuous. But when the crisis ends, differences will re-emerge.

When a plane taking off from New York almost crashed last month, the health and well-being of all the passengers hinged on how the crisis was resolved, without this depending on their youth, cholesterol levels, excess weight or the state of their lungs. The drama was the same for everybody. Luckily, they all emerged safe and sound from the landing on the Hudson. But after that, with the crisis behind, their health and well-being depends once again on the state of their organs, diet and exercise, and on taking the right medicine.

Countries worldwide have entered into a similar negative spiral (a deep slowdown in – and in some cases the collapse of – consumption, employment, output, credit, investment...). And that might feed the illusion that, once the recession is behind, all countries will recover in the same way. But that will not be so. Each country has singular features that will prove pivotal when defining the path to follow once the crisis is over. Accordingly, my reflections will focus on what distinguishes us from others.

The Spanish experience shows that, from 1985 to 2008, growth in the economy was outpacing the EU average, with the sole exception of 1992 and 1993. This spectacular growth over the past 23 years has allowed us to draw closer to the welfare levels enjoyed by the most prosperous EU countries. But what will happen to the Spanish economy when we emerge from the current crisis? Will we witness such satisfactory growth as in the past?

The reply, as always in economics, is that “it depends”. If we do what we have to do, if the necessary reforms are made, we will once again grow above the European average. But if we do not reform we will probably grow at or below the EU average, with convergence with our main economic partners being checked.

Yet if we have been able so far to advance without these reforms, is it absolutely vital to adopt them now? Before answering that, let us look at the causes of growth in the Spanish economy in recent decades. Such high growth may prove surprising given our economy’s shortcomings or weaknesses: a much lower level of educational attainment than other European countries, low capital stock, inferior technology and labour institutions which, as we shall see, do not generate the incentives needed to enhance individual and collective efficiency. Why, despite this, have we grown so much? Partly because we made more progress than the other countries in some areas, which has offset our relative shortcomings.

First, the relative weight of our public sector is much lower than that of the other European countries. Consequently, the greater weight of the private sector accounts for the greater dynamism of our economy. Next, public spending has been decentralised in a manner akin to Germany after World War II, and, to date, that has allowed greater efficiency in the allocation of spending. Further, we have also been bolder than other countries in privatisation. In recent decades there have been many significant privatisations in practically all productive sectors, allowing us to push ahead more than other economies in infusing competition into many goods and services markets. Unlike in other countries, privatisation has been wholesale, which is essential for breaking the link between corporations and governments. Finally, up to 2007 Spain managed notable progress in terms of balancing public finances and reducing public debt. All these aspects might be viewed as some of the inherent virtues of the Spanish economy, which account for much of our favourable growth differential over the past 20 years.

What is most surprising is that our economy has been growing despite progressively losing external competitiveness. The growth of our prices, unit wage costs and business margins has outpaced those of the euro area. This has ultimately resulted in a sizable current-account deficit which, though it may be seen as excessive investment relative to saving, also indicates Spain’s insufficient competitiveness, with very poor productivity gains.

And how has it been possible to grow in the last 23 years despite losing competitiveness? Because in addition to the above factors or “inherent virtues”, Spain has had access to other possibilities which have also helped it grow. There are two in particular.

The first was the resort to devaluation. Though the last devaluation was in 1995, this instrument was available until 1999, when Spain entered the euro area. Devaluation allowed losses in competitiveness to be absorbed – without the labour market being reformed or corrective measures being taken to enhance productivity – by means of reducing real wages, increasing import prices and improving the relative prices of products sold abroad.

But let’s not deceive ourselves. Periodic devaluations, though providing temporary relief that allowed necessary structural adjustments to be postponed, entailed huge costs and kept private agents in a setting of financial and exchange-rate instability far from conducive to sustained growth.

During our decade in the euro area we have also grown at a higher rate than our partners, despite not having the resort to devaluation. How has that been possible? Along with the effect of the positive factors I mentioned earlier, we should also highlight euro area membership for

what it has meant in terms of stability and reducing uncertainty, and the contribution of immigration, which has added notable flexibility to the Spanish economy.

Unquestionably, though, a decisive factor in growth from 1999 to 2008 was the extraordinary increase in household and corporate debt. In that decade, Spanish domestic demand growth was double that of the European Union because private agents' debt rose twofold in the 1999-2007 period. As a proportion of gross disposable income, household debt climbed from little more than 60% to 130%, and corporate debt from 270% to almost 600% of the gross operating surplus.

The problem facing us on emerging from the crisis is that although this swift indebtedness drove the increase in domestic demand and, therefore, in economic growth in recent years, the high level attained will prevent debt from growing in the future at a similar rate to what it did in the past. Moreover, for several years we may well witness a debt reduction or deleveraging process, meaning its effect on domestic demand will be the opposite of what it was in the past, reducing our growth rate.

The Spanish economy's main problem, then, is that its future looks very different from its past since the two possibilities I mentioned – devaluation and increased debt – have disappeared. Thus, even if our economy's many strengths (a very small public sector, privatisation, low public debt, etc.) remain in place and there is no slippage in progress made, Spain will face more demanding situations for having forgone these two possibilities. Naturally, were we to back-track on competition, for instance, or were the budget deficit to surge to unsustainable levels, our growth would be even more severely impacted, as occurred in the past decade in some European countries.

The only possible means here of recouping the external competitiveness lost following the latest upturn is to increase our productivity. And higher productivity, in addition to requiring a priority focus on education and training, inevitably involves structural reforms in numerous fields. As we have limited time, I'll refer exclusively to the reform of labour institutions, where the Banco de España researchers have made most valuable contributions. Also, this is surely the reform that can most contribute to resolving the problem most concerning Spaniards, namely unemployment. Yet while not mentioning them today, we should remember there are many other vital structural reforms needed, such as that of the rental market, boosting competition in services, railway freight transport, energy, public administration, etc., and that can also contribute to enhancing productivity and to a return to higher growth than the EU average.

Clearly, inadequate labour institutions generate very harmful effects not only on productivity and economic growth, but also on employee welfare. Spaniards need little convincing of the problems unemployment poses, problems which assail us even when the business cycle is buoyant. In the past year we regrettably posted once again the highest unemployment rate in the OECD; and furthermore, the speed at which joblessness in Spain is increasing during the current crisis is the fastest among all the developed countries.

In countries facing a contraction in activity similar to that in Spain, the unemployment rate rose only slightly last year (e.g. by 0.2 pp in France), or even fell (Germany). We might argue that these countries show much lower increases in the labour force than Spain and that the expansion in their construction sectors was not comparable. The problem is that when we compare with countries that do have these two characteristics, such as the United States or the United Kingdom, Spain's unemployment increase continues to stand out. Specifically, the US unemployment rate rose by "only" 2.3 pp in 2008, somewhat more than in the United Kingdom,

where the increase from January to October 2008 was 1.4 pp. These are very moderate increases when compared with the figure of over 5 pp for Spain in 2008. Evidently, the Spanish economy's labour adjustment mechanisms are not working properly.

Another harmful effect of an inefficient labour market is that it reduces the room for workers' real compensation to improve. In recent years, the Spanish economy has had to compete abroad on the basis of holding down its real labour costs, which was imposed by the economy's low productivity. This has direct consequences for everybody's welfare, particularly so for those groups most adversely affected in terms of both wages and unemployment, namely women and the young.

These particularities of workers' situation in Spain compared with other developed countries – higher unemployment, even in the good times, a swifter increase in unemployment in adjustment phases, lower real wage growth, lower labour productivity growth, greater discrimination against certain groups – match the singularity of our labour institutions when compared with those countries. There is a long list of areas where we differ: the practical impossibility of opting out of collective bargaining, the scant share of compensation in corporate profits, wage indexation mechanisms with no connection to firms' situation, State intervention through mandatory authorisations that prevent firms from increasing their productivity, etc. But as time presses, I'll focus on just one of these particularities: the way in which we provide for the unemployment contingency.

Spain continues to adhere to unemployment contingency arrangements which, formerly, were similar to those in other European countries, but which have all been reformed in recent decades. Under our system, assistance to the unemployed combines a government benefit with the payment of a one-off amount related to the time the beneficiary was at a single company. This amount is payable by firms, not the State, and it is occasionally the biggest portion of the assistance to the unemployed. All these features lead to numerous inefficiencies in the system, which makes for lower productivity and categorical failure in the goal of reducing unemployment.

Under its current design, unemployment compensation is an absolute deterrent to labour mobility, since it depends on workers' years of service at the last firm at which they were employed. And in today's world the reallocation of workers from one firm to another is crucial if the economy is to adjust suitably to the rapid changes unfolding in demand and in technologies. In that way, workers move from firms in decline to those pursuing more productive activities. The compensation system in force is not conducive either to the start-up or growth of more productive firms. And not only because it deters employers, discouraging new hires. Spanish workers themselves ultimately do not accept changing job because even though more productive firms may offer them substantially better wages, the change does not compensate for the fact that any severance payment would be back to zero in their new job.

The fact that unemployment protection largely resides on a compensation package (which is colloquially known as firing costs) payable exclusively by the private sector also adds numerous distortions. The fundamental one is that it discourages company start-ups and hiring in general, a matter which, while important, is all the more so now that the inevitable and massive reduction in employment in housebuilding needs to be offset by job creation in other sectors.

The Spanish system is inefficient. Yet it would be absurd to ignore the fact that the Spanish public largely believes the current system protects workers. And clearly, if there is no widespread awareness of the harm the system causes, there will be no reforms. It is therefore absolutely vital to study and publicise the reforms other European countries have undertaken,

choosing those alternatives that allow us to raise our productivity, and thus our external competitiveness, to increase our per capita income and quality of life, and to improve the conditions of the most disadvantaged groups.

In many respects the current situation of labour protection can be equated with the trade protectionism characterising the Spanish economy until the late 1950s. During that period, import tariffs and quotas were very high in comparison with those in other developed countries. The belief until then was that trade protectionism shielded Spanish firms and workers, but nothing was further from the truth. The goods sold in Spain were expensive and of poor quality, workers' wages were so low that attempting to hold down two jobs was the norm and the level of per capita income even fell relative to that of our trading partners.

The situation changed radically with the opening up of the Spanish economy, when we began to resemble other developed countries. Indeed, this process, which started with the 1959 Stabilisation Plan and culminated in accession to the European Union in 1985, has seen Spain successfully converge on European standards of living. The opening up of the economy did not only not lead to the disappearance of industry and agriculture; it also raised Spaniards' standard of living significantly.

In short, what was apparently a singular system protecting us was leading us down the road to disaster. It was not until an acute crisis hit us hard at the end of the 1950s that we realised that what distinguished us from other countries and what we thought was protecting us was actually achieving the opposite.

It is now precisely in Spain, where employment protection purports to be in good health thanks to the high unemployment severance packages on top of government benefits, where labour shedding in the face of the current economic crisis is proving fiercer than in other countries. For this reason we should study the experience, for example, of Austria and Denmark, whose labour market reforms can offer us some ideas for reform at home. In Denmark, where the unemployment rate is 4.1%, the authorities opted to improve regular benefit payments and to practically eliminate redundancy payments. In Austria, where the unemployment rate is 3.8%, firms set up an individual fund for each worker which becomes available if workers loses their job, acting as a top-up to government unemployment benefits. When workers find employment in another firm, the unused portion of the fund goes with them and starts growing once again with the new firm's contributions. At the end of their working life, the funds available are an additional source of retirement income.

The virtue of these systems is that they do not deter worker mobility. This is so in Austria because, by not forgoing their "established rights", it is workers themselves who manage the accumulated resources during periods in which they are unemployed. Also, this arrangement offers protection to all workers, even those whose previous terms of employment have been short-lived. In Denmark, the choice was of a system which firmly supports the unemployed (with substantial unemployment subsidies and intensive training programmes) in a setting in which, however, firing costs are very low.

Just as 50 years ago the external sector crisis obliged Spain to change its trade protection policy, the current, serious unemployment crisis should lead us to examine what we can change in our labour market, given what other countries have done with very favourable results. Admittedly, this is nothing new, since the Banco de España has reiterated in its annual reports, at least in the past 10 years, the need for such reform. What is new is that reform has now become absolutely vital; otherwise, when we emerge from the current crisis, and in the

absence of the instruments that were used in the past, we will be liable to grow far below what we did in previous decades.

The reform of labour institutions is a pressing task, since the short-run effects on hiring are absolutely necessary in the current circumstances. But we require action on another front, even though the effects are longer-term. I refer to education. Undoubtedly, progress in education is Spain's most important outstanding task in respect of economic growth, enhanced productivity, fairer income distribution and also the attainment of low unemployment. True, Spain has advanced in some fields here, such as university education and business schools. But we continue to take up the rear as regards the average quality of our citizens' educational attainment, with the serious consequences this entails.

It is well known that countries with a better educated population are characterised by having higher wages, lower unemployment rates and a higher labour market participation rate. For example, both in Denmark and in the United Kingdom, more than two-thirds of the population have a post-compulsory education qualification, as against only 50% in the case of Spain. In both countries, the average worker has 30% higher spending power than Spanish workers, and their unemployment rates in 2007 were 3% and 5%, respectively, less than half the level in Spain.

This relationship between training and wages is explained by the fact that more highly educated workers are more efficient, and therefore obtain higher wages, and by the fact that employers always prefer to fire the least productive workers. In fact, the unemployment rate in Spain for persons with only a primary education has increased in 2008 by almost 8 pp, as against 5 pp in the case of those with a secondary education and only 2 pp in that of persons with a further education. The data also show that not only are the largest increases in the unemployment rate among groups with lower levels of education, but that these groups also have the highest unemployment rates.

Yet we should not only strive to improve the educational attainment of our workers before they start working. We should also promote training within the firm. If we managed to make our labour market institutions more like those of other developed countries, we would also do away with labour market arrangements that hinder workplace training and do not give employers any incentive to improve their firms' human capital.

We urgently need a debate between all political, economic and social agents to convince them of the need for reforms. The government and the parties who support it, the opposition parties, trade unions, employers, academics, researchers and the media should all participate. And we should not forget those who the reforms would benefit most: unemployed workers and employers who still do not exist, but who would be able to if there were a significant structural change in labour market institutions.

Without sufficient social acceptance this debate will obviously not even be joined, so it is very important to clearly underline the objectives pursued which I've repeated ad nauseam in this speech, but which I shall attempt to express again in a different way so as not to tire you. We should all agree that the best protection against unemployment is not that which concerns itself with subsidising the unemployed, but that which ensures that the majority do not lose their job. We should admit that it is useful to allow employers to improve their productivity because that way we will see higher real wage growth. And, finally, we should let workers take the opportunity to switch to better-paid jobs without losing a substantial part of their protection in the event that they lose such jobs.

You will have realised that my approach to the debate on labour market reform is far removed from that of those who confine it to the question of whether or not to lower dismissal costs. In my view it is a mistake to debate cheaper firing alone, and I believe that we can only make headway if we focus on finding formulae that allow us to increase productivity, to reduce the numbers of unemployed and to improve workers' wages.

The fact that Spain is today more advanced than other European countries in many areas that I mentioned at the start of my speech should not let us forget that there are still some fields in which we can learn from others. It is precisely this attitude of having learnt from others, and made the consequent reforms, which largely explains the positive performance of the Spanish economy in recent decades. In my opinion, the time has come to do the same (to learn and to reform) with labour market institutions which, as systematically stated by international organisations, are the major structural difference remaining between us and the more developed countries.

We must acknowledge that the task is not an easy one. Apart from convincing people about their necessity, something historians and economists can help do, the skills of many others will be needed to design and implement the reforms. One thorny issue is how to set some changes in motion immediately and, at the same time, be sensitive to what may be seen as an alteration of established rights. Political acuity is crucial to resolve these problems, as indeed it is also to make the interests of the different groups of workers compatible with each other. But it should also reassure us to know that the reform toolbox is full of possibilities: calendars, compensation, incentives, etc. Lawyers also have an important job to do, since the problem with all structural reforms is that they alter the status quo and, accordingly, it is essential to find legal formulae that circumvent the obstacles that may arise in their approval and implementation.

The difficulties that may arise, not only when reforming but also in opening the debate, may lead some to ask why, without reforms and, in particular, without modifying our labour market institutions, Spain won't be able to grow as in the past. From what I've said already you can imagine my reply. It is possible that Spain may be able to grow as in the past, but it is highly unlikely. And I say that it is possible solely because, following the general failure of most of the forecasts that have been made during the current crisis, we should all be more humble when postulating about the future. Honestly, though, it is more difficult to imagine today how, without reforms, the Spanish economy can perform as favourably in the future as it has done in the last few decades. Moreover, what do we gain by refusing to learn from others about what can reduce the rate of unemployment and raise labour productivity and real wages? Even if our economy can grow again as it has in the past, with low productivity and with higher unemployment and lower wages than our neighbours, that would not seem to be preferable to the strategies for growth that they apply.

Allow me one final consideration on an argument occasionally deployed, when there are no other arguments left, for not adopting structural measures. These reforms, it is said, may work very well, but they should be postponed until later because they are not useful for exiting the current crisis. Firstly, some of these reforms, such as those conducive to hiring, would clearly have immediate effects in resolving the main problem of the current crisis, namely unemployment. Yet while it is true that other structural reforms would not have immediate direct effects but would yield future results, the decisions economic agents take today depend greatly on how they see the future. What has brought decisions to consume and invest today to a grinding halt is mistrust of the future; accordingly, if confidence about the future is restored, that would have highly beneficial effects not only in the medium run but now, in the present.

In sum, tomorrow we'll broach again the financial and real-sector crisis facing us. And how to exit it. We'll be reflecting on how to break the vicious circles of the lack of confidence. We'll discuss how it is naive to believe these vicious circles can be broken only in one place, concluding that what we need is a recovery in the confidence of all economic agents. These measures cannot be taken only at the national level; the crisis is a global one and attempts should be made to coordinate action to the full worldwide. That makes very strong demands on all multilateral fora and institutions, governments, politicians, central bankers, supervisors and all those with responsibilities in the matter. We must all continue doing all we can to emerge from the current situation.

Today, however, I wanted to pause and look beyond the crisis. For one thing, we do not know how deep and long it may be. But what is certain is that this crisis will end. We are certain we will finally emerge from it. This is not wishful thinking, but an empirical regularity. The economy has worked this way at least since the time Joseph interpreted the Pharaoh's dream about lean and fat cows.

I wanted to focus today on the future of the Spanish economy because the essentially macroeconomic dimension of the current crisis makes us forget certain things: that our main problems are structural; that our chief task is to improve and boost productivity; that we ought to seize the moment to reform our regulations and institutions; and because whatever we do to improve productivity does not run counter to exiting the crisis but, quite on the contrary, may help us emerge more rapidly from it.

To conclude, let me reiterate what I said earlier. If I've talked of only one area of structural reform, namely labour reform, it is because I think it is the most important one for re-launching corporate start-ups and reducing unemployment. But is it not the only area of reform, and nor are others less necessary. Giving a greater degree of legal security to rental contracts, and liberalising the related terms, is absolutely necessary for reducing rental costs and for making a smoother real estate adjustment, without a collapse of the value of the wealth in which Spaniards have their assets concentrated. Re-launching privatisation, liberalisation and the boosting of competition in numerous sectors is vital because, by reducing unwarranted business margins, workers' real wages can be increased without harming competitiveness. And thus we could say for many more areas of reform. But we'd need many more speeches to talk about this. And fear not, I won't be making them today.

Thank you.

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