TESTIMONY OF THE GOVERNOR OF THE BANCO DE ESPAÑA, MIGUEL FERNÁNDEZ ORDÓÑEZ, TO THE PARLIAMENTARY COMMITTEE ON ECONOMIC AND FINANCIAL AFFAIRS

Testimony of the Governor of the Banco de España, Miguel Fernández Ordóñez, to the Parliamentary Committee on Economic and Financial Affairs

The performance of the Spanish economy referred to in the annual report of the Banco de España forming the subject-matter of this appearance before Parliament is, as you know, set against a background of financial and economic crisis which is worldwide and without precedent for many decades.

The origin of the crisis – which dates back to the summer of 2007 – was eminently financial and its propagation was hastened by the globalisation of financial activity. The activity of the international financial markets suffered severely, practically coming to a standstill in some of them. The financial tension reached its peak in October 2008 and, although it has ebbed in recent months, still remains at relatively high levels.

The seriousness of the financial shocks prompted a deep real crisis which affected the world economy with unheard-of intensity and simultaneity, pushing most developed countries into recession at the end of 2008. From 2008 Q4 contractions were seen in the activity of many countries and in world trade, which worsened in the first quarter of this year. However, activity may have already bottomed in that period, since the most recent indicators suggest that, although production will probably continue to decline, it will do so more moderately, which seems to indicate that the risk of a recessionary spiral in the world economy is more remote.

The dimensions of this crisis and the multiplicity of its ramifications mean that a response on various fronts is required to prevent it from recurring. It is evident that the financial crisis has revealed numerous shortcomings in financial regulation, which must be dealt with promptly. Moreover, it is necessary to analyse why the structural weaknesses of economies and of financial systems were not detected or corrected in time, thereby permitting a contagion of considerable size to be triggered. With the benefit of hindsight, it seems clear that the economic policies of past years were generally too permissive of the imbalances generated by the growing indebtedness during the high-growth stage.

It is therefore essential for the authorities to examine critically the institutional and regulatory frameworks of their economies and financial systems and design mechanisms to reinforce them, so that mechanisms can be set in place to prevent a crisis like this one from being repeated.

That review should encompass various basic areas. I will leave for later those concerned with financial regulation and supervision policies and will now focus on the need for examining the role of macroeconomic policies. This examination should assess the part played by them in the gestation of the crisis and analyse how their design can be optimised to make it more suitable for correcting imbalances such as those seen in recent years. In the fiscal policy sphere, the lack of a more powerful stabilising role in the high-growth years was noted with regret, since it would have balanced the momentum of private spending and helped to keep public finances on a more sustainable path in the medium and long term. In regard to monetary policy, more attention must be paid to the role of central banks in stability strategies.

Many of the measures adopted by economic and monetary authorities in recent months were based on common principles agreed jointly in the framework of different international fora. In the case of the European Central bank, unprecedented expansionary measures were set in train to alleviate the contractionary trends apparent both in the real economy and in the financial sector. The provision of liquidity was made more flexible from the very summer of 2007, although it was from October 2008 when the changes became more substantial, since institutions' requests for liquidity began to be met in full and the range of financial assets eligible as collateral for those operations was widened. Since summer 2008, the policy interest rate has fallen by 325 basis points to stand, following the meeting last May, at a historical low of 1%. In the field of exceptional measures, mention should be made, among others, of the lengthening of the periods for which liquidity is provided, which now extend up to 12 months, and the recent decision to admit the outright acquisition of mortgage covered bonds.

Governments have also adopted numerous measures to combat the financial crisis. They fall into two broad groups: those intended to support the financial systems and those designed to boost spending. The first group includes a wide variety of instruments ranging from the extension of bank deposit guarantees, through the granting of State guarantees for bank securities issues, to the injection of government capital in some institutions and the purchase of problem assets forming part of bank portfolios. Of the measures to stimulate demand, mention should be made of the operation of automatic fiscal stabilisers, which are very important in the European economies, and of the specific government spending or tax cutting measures to support the groups or sectors hardest hit by the crisis.

The measures by the Spanish authorities generally follow these same lines. Thus in Spain they are as follows: deposit guarantees were extended, a Fund for the Acquisition of Financial Assets was set up to purchase high-quality assets from Spanish institutions; guarantees are being granted for the issuance of bank bonds; the opening of diverse lines of special financing through the ICO was approved; new personal income tax credits were introduced; and the so-called State Fund for Local Investment and the Special State Fund to Invigorate the Economy came into operation. More recently, new measures to spur demand (such as car purchase assistance) have been announced, and the finishing touches are being put to a Bank Restructuring and Organisation Fund, which will serve as a tool for revamping the Spanish financial system.

Let me now focus my attention on the situation of the Spanish economy. The international crisis came at a particularly delicate time for Spain, since the economy was already undergoing the adjustment of certain imbalances which had accumulated during the long stage of high growth from the mid-1990s. The imbalances in Spain had some points in common with those detected at global level, but also some specific features.

As in other countries, the buoyancy of private sector spending in Spain was based on a rapid increase in household and corporate debt, spurred by low initial levels of debt and by favourable financial conditions arising from a monetary policy stance which during that period was too lax for the conditions of the Spanish economy. The financial laxity also led to an excessive concentration of economic and financial resources in the real estate sector, and this subsequently added to the severity of the adjustment phase. For its part, fiscal policy undertook a significant process of consolidation, but its contribution to the moderation of domestic demand was not sufficient to offset the effects of the monetary laxity.

As you are well aware, the Spanish economy underwent a very severe adjustment in the second half of 2008: GDP showed negative quarter-on-quarter growth rates from Q3 onwards, increasingly so until 2009 Q1, in which activity decreased by 1.9% with respect to the previous quarter, this coming on top of the fall-off of 1% in the fourth quarter of last year. This contraction led to a year-on-year fall of 3% in GDP in 2009 Q1. The economic data for Q2 are not yet conclusive, but in any event suggest that activity is not contracting as quickly as in the previous quarter.

In the Spanish recession, the strong impact of the international financial crisis was superimposed on the real estate adjustment, which had begun to have an effect some time before. The size of the resulting shock was substantial and it deeply affected the confidence of agents and depressed spending decisions and employment behaviour.

A notable development in 2008 was the sharp decrease in household spending, which hit both consumption and residential investment. But the worsening of the financial crisis from summer onwards and the deterioration of the macroeconomic outlook meant that other items were also affected, for instance corporate investment. This sharp fall in domestic demand brought a substantial decrease in imports and, as a result, the contribution of net external demand to GDP improved, dampening the fall-off in activity.

The contraction of private spending meant that some of the imbalances accumulated in previous years began to be adjusted. Net lending by households increased, with a notable rise in the rate of saving, and net borrowing by firms decreased. All this was reflected in a fall in the nation's net borrowing, the rate of which has gradually quickened over the last few quarters.

The weakness in activity gradually spread to all productive sectors, with decreases in employment, initially in construction but subsequently in industry and, finally, services. There was thus widespread job destruction, which became extremely intense in late 2008 and early 2009, and a very substantial increase in the unemployment rate to 17.4% in 2009 Q1.

While the recession in Spain in terms of GDP growth is less serious than in other European countries, the sharp increase in the unemployment rate is a characteristic feature of Spain which is particularly harmful and reveals a basic weakness of its institutional structure which must be corrected.

One of the problems of the workings of the labour market relates to the insensitivity of labour costs to the particular conditions of each firm or to changes in the business cycle. Specifically, in 2008 labour costs increased markedly, a development which reflected the deteriorating inflation owing to the sharp oil price rises in the first half of the year. Although pressure from wage costs seems to have begun to ease in 2009, their rate of change is insufficient with respect to the path of inflation and to the recession currently besetting the economy, and, accordingly, the resulting real wage growth will not be conducive to job creation.

In recent months it has become apparent that the current recession, which is sharply affecting household consumption, is also causing downward revision of prices and margins. Thus in May the year-on-year rate of change of the CPI was -0.9%, the lowest level since the mid-1900s, 0.9 pp below the euro area inflation rate. Although by the end of the year these year-on-year rates will foreseeably turn positive again once the statistical effect linked to the oil price rises in the early months of 2008 peters out, it was nonetheless notable that May saw year-on-year decreases in food and industrial goods prices. Also, in services, which is traditionally the most inflationary component of the Spanish economy, a gradual moderation is taking place. This price behaviour is in the appropriate vein for improving the competitiveness of the economy, reducing the costs of the recession and initiating a solid recovery.

The outlook for the Spanish economy is that GDP may continue contracting for the rest of the year. The resulting fall for 2009 as a whole will be very substantial, although probably less than in other European countries, more affected by the slump in world trade in recent months. Although GDP may continue to fall in 2010 in annual average terms, it will do so at a less pronounced rate, since the wide range of measures taken should gradually moderate the intensity of the shocks constraining activity. However, given the extent of the adjustments bearing on employment, the unemployment rate may yet remain on an upward path.

It is true that some imbalances accumulated during the expansion are being corrected. As just mentioned, the inflation differential with respect to the euro area is now favourable to Spain, while the external deficit is falling sharply in a trend which will foreseeably continue, such that, as a ratio of GDP, in 2010 it will fall to less than half its value in 2007. Although Spain should insist on reabsorbing these imbalances, it is undeniable that the improvements obtained are linked to an abrupt contraction in demand, with highly negative effects on the unemployment rate and the productive system. It is thus essential to change certain aspects of Spain's institutional framework to prevent these losses of jobs and productive capacity from becoming entrenched and hindering recovery and to ensure that the imbalances of recent years do not reappear when demand starts to grow again.

In the recovery of the Spanish economy, as in the case of the world economy, a major contribution will be made by the special measures adopted in demand-side (monetary and fiscal) policies and in financial system support. However, in Spain, where domestic demand is very much affected by the need to strengthen the financial position of the private sector and by the impact of the high unemployment rate, reliance will have to be placed on the recovery of external demand as the principal driver of spending. To capitalise on the improvement in external demand when it comes, firms will have to be able to offer competitive products, and to do this they will have to increase their productivity and adjust their costs, margins and prices flexibly.

The substantial cuts in official rates of central banks throughout the world in the past year have prompted a significant drop in the cost of financing. In Spain the resulting expansionary stimulus is particularly powerful because of the predominance of variable-rate financing. This boost will be particularly notable in certain sectors, such as residential construction, in which the combination of lower interest rates and price adjustments will make houses more affordable for households.

As in other countries, fiscal policy in Spain also contributed to cushioning the decrease in activity, through both the action of automatic stabilisers and the adoption of diverse discretionary measures. This fiscal effort, of considerable size, generally exceeds that of other EU countries. Moreover, in Spain, the loss of revenue due to weaker spending came on top of the drying-up of the wind-fall revenues made possible by the housing boom of the past decade. All this meant that the general government balance worsened considerably, swinging from a surplus of more than 2% of GDP in 2007 to a deficit which, according to the latest figures announced by the government, may stand at nearly 10% of GDP in the current year.

These developments have exhausted the possibilities of expansionary fiscal policy action. The fiscal imbalance has reached a level at which a corrective strategy is required, and this strategy must be credible so that agents trust that budgetary stability will be maintained in the medium run. In this respect, the government has just announced the budgetary stability targets for the period 2010-2012 committing it to an enormous effort in fiscal consolidation. It aims to cut the deficit from the nearly 10% of GDP that may be reached in 2009 to 3% in 2012, thereby complying with the guidelines set for Spain by the European Council in respect of compliance with the Stability and Growth Pact. The size of the envisaged correction in such a short space of time calls for a strict budget outturn and the adoption of energetic measures. The recent increase in some indirect taxes is an initial step in this direction, although past experience shows that for fiscal consolidation processes to be successful, they must focus on cutting government spending, particularly that which is unproductive. In this respect, the regional governments, given their share of government spending, will have to contribute actively to getting the country back onto the path of fiscal consolidation and budgetary stability.

In any event, although monetary and fiscal policies have played an extremely important role in offsetting the huge contractionary forces bearing on economies, this policy support cannot continue to be relied on once the recovery commences. Governments and central banks have to design "exit strategies" for terminating the current extraordinary fiscal and monetary policy action, so as to prevent future processes of economic instability from taking root. For this purpose, the policy effort will have to concentrate on reforms aimed at improving the productivity and performance of the factor and product markets. Unlike in the field of demand-side policies, here the room for action is ample and, in addition, its potential effects are significant.

As noted above, one of the main problems of the Spanish economy lies in the labour market. The current crisis has caused the unemployment rate to surge once again, reminding us that adjustment in the Spanish economy basically takes place through job destruction. Action is needed to prevent the higher numbers of unemployed from becoming a permanent phenomenon and their level of employability from deteriorating rapidly. Action is also needed to enable the rapid reallocation of resources across sectors, so that the slack in real estate activity can be smoothly taken up by other productive sectors.

The labour reform is unavoidable and must address different areas. In the field of collective bargaining, it seems that labour and remuneration conditions have to adjust more flexibly to the economic situation, particularly that currently being faced by firms or specific productive sectors. It is also vital to make changes to the recruitment systems and to improve the labour market intermediation systems and the mobility and training of the unemployed, so that workers who have lost their jobs can find new opportunities promptly. These reforms would not only improve the medium-term growth outlook of the Spanish economy, but would also help to prevent deterioration of the productive system.

Obviously, although the labour market is important, it is not the only area calling for reform by the Spanish authorities. Closely linked to the labour market is the issue of human capital and education, where it bears repeating that, although the returns are primarily in the medium term, the need for reform is urgent. Finally, in Spain it is essential to establish a much more solid competitive environment, in which firms can operate more efficiently and on an equal footing with those of other countries. Services play a key role in this environment since they account for a growing share of industrial activities. Furthermore, the lack of liberalisation of some segments may be limiting their expansion. This is particularly pernicious because the services sector encompasses some of the most dynamic activities with the greatest capacity to generate employment. In this respect, the government's recently proposed initiative to implement the Services Directive through a draft law involving action in numerous areas must be applied resolutely, and, for this purpose, regional and local government will have to cooperate in their areas of competence. Also, fomenting competition in the network industries would enable inputs to be supplied to other productive activities under more competitive conditions.

To conclude, let me briefly review the situation of the Spanish banking system.

The distinguishing feature of the situation in Spain is that this crisis found Spanish credit institutions in a relatively strong position. Their business model was the traditional one, focused on the retail segment and evolving separately from those more sophisticated models which have seriously damaged the institutions – and even the entire financial systems – of other countries. This explains why the weight of toxic assets in the balance sheets of Spanish institutions is insignificant. Also, the Banco de España helped to strengthen the starting position of Spanish institutions vis-à-vis the crisis, since it required anticyclical provisions to be set up to lessen the pressure in tougher times and it defined sufficiently wide scopes of consolidation for banking groups to enable accurate valuation of the risks assumed.

These strong starting conditions enabled the Spanish financial system to withstand the first wave of the financial crisis and to continue channelling the necessary inflow of foreign saving, although by different routes, since the paralysis of the securitised asset markets meant that alternative sources, such as short-term paper issuance and ECB loans, had to be tapped. Deposits gained in relative weight during the first phase of the tensions.

However, the transformation of the financial crisis in recession gave rise to a second wave of risks for financial stability, this time of an eminently macroeconomic nature. Although the Spanish financial system faces this second wave with the relative advantage of having been less damaged by the first, the deterioration of the Spanish economy unquestionably puts pressure on bank income statements in a number of ways.

Specifically, job destruction is impairing some households' ability to pay, while the decline in activity is being particularly noticed in the real estate sector, which required abundant financing and had acquired a high relative weight in the balance sheets of some institutions. Hence, after a long period of economic expansion in which doubtful assets ratios fell to historical lows, since 2008 they have been rising significantly and foreseeably the pressure has not yet run its course. In addition, lending activity has slowed substantially as a result of both demand-side and supply-side factors, and lending can be expected to grow more slowly than GDP in the coming months, as has occurred in other similar cycles.

These two factors – slower banking business growth and rising bad debts – put pressure on Spanish banks' income statements in 2008. However, the traditional banking model, much less dependent on financial market performance, along with the still-favourable rates at which spreads were holding, allowed earnings to remain positive despite the difficult economic situation.

However, this pressure on Spanish institutions' income can be expected to continue in the future due to the foreseeable increase in bad debts and, in the more medium term, to the downward pressure that the competition for funding will put on operating margins, against a background of deleverage of the financial sector and, in general, of the economy, which is taking place both in Spain and globally and which cannot be considered a temporary phenomenon.

I am convinced that the Spanish financial system can overcome these challenges, although, as I have repeated on various occasions, banks will not be immune to the crisis and not all of them start from the same position when it comes to confronting this difficult stage, since they followed different credit policies in the past and managed their risks in different ways. In any event, banks necessarily have to adapt to the new circumstances, and so have to rationalise their operating cost structures and correct the excess capacity of the sector.

The financial system plays a central role in any economy, since it is fundamental in the allocation of financial resources. This role explains why the State, like other governments, has shown its readiness to provide capital to the viable credit institutions that need it. These contributions of capital must not, of course, be unconditional, but rather subject to the restructuring of the institutions that receive those public funds, so as to seek both the lowest cost for taxpayers and maximum efficiency of the system. It should be noted that, moreover, this approach is fully in line with the common principles agreed in international fora and expressly backed by this Parliament with a broad consensus. I trust that these principles and this spirit of cooperation in matters of general interest related to the stability and strength of the Spanish financial system can soon be manifested in a set of legal provisions which will strengthen the capacity to take action as and when problems arise, in line with the tradition of the Banco de España and in accordance with the specificity of the serious tensions now being faced.