CONFERENCE on occasion of the CENTRAL COUNCIL

"Back on the road to growth - Spain and Portugal after the structural reforms"

Madrid, Thursday June 12th 2014

Prior to its summer Central Council in Madrid, the European League for Economic Cooperation held a well-attended conference on the economic recovery in Spain and Portugal, two countries in the European Union that were worst hit by the crisis. The debate with more than 10 high ranking experts, concluded that Spain and Portugal are back on the road to growth, but that the crisis is not over. The Monetary Union and the structural reforms that have been taken, have to be supplemented by a deeper European integration in a wide number of fields, including the single market.

In his word of welcome Carles Gasòliba, President of the Spanish section of ELEC, referred to the saying of the Spanish economy minister that the recession may be over, but the crisis is not. Antonio Martins da Cruz, President of ELEC Portugal, remarked that Iberia may be a geographical entity, but that Spain and Portugal are very different both politically and economically- although during the last elections there was a strong anti-European integration vote in both countries. Gasòliba and Martins da Cruz both thanked the BBVA and its European affairs officer Javier Arias for putting together the conference program and receiving ELEC at its La Moraleja campus.

Commissioner Almunia during his keynote speech

A first introduction from the Spanish side was given by **José Manuel González-Páramo,** Executive Board Member of **BBVA**. Economic growth has returned to Spain, Portugal and the euro zone. Interest rate spreads have decreased. But inflation is too low and the crisis is still with us. The fragmentation within the EMU still exists. The first reaction of politicians to the crisis has been firefighting; only in a second phase institutional reforms were launched. The new commission will have to decide whether it wants a standstill or decides for a more ambitious integration. The recent creation of the Banking Union was the biggest transfer of sovereignty ever. The single supervision of 6.000 banks by the ECB poses a great risk, González-Páramo warned. We will have to protect the ECB from enthusiasts that endanger its reputation because in the future there will still be banks that fail. It will take time to break the vicious circle between banking en sovereign risks. Legacy problems and relations with third country supervisors will have to be tackled. A deeper economic, fiscal and political union remains necessary. "We left the recession, but the challenges remain", he concluded.

Francisco Almeida Leite, former Portuguese secretary for foreign affairs and now executive administrator of the **Sociedade Financeira para o Desenvolvimento**,

referred to the great success of the initial integration of Portugal into the European Union bringing higher economic growth and prosperity. But after three decades the twin deficits surfaced, together with the competitiveness difficulties and the low interest rates that pushed up public and household debt. Since then Portugal has been doing an enourmous adjustment effort. That positive result should not be lost. The public deficit has been reduced from 9.8% to 4%, and the primary budget is back in surplus. The banks have stabilized and deposits and savings have gone up, a clear sign of confidence. Structural reforms have been applied to improve competitiveness. 450 measures have been taken - on average 3 per week – in the labour market, business environment, and the openness of markets. Portugal is now considered a good student. Leite summed up the reform agenda that is still in the pipeline. He has no doubt that Portugal will attract foreign investments and that it will successfully exit the European bailout program. Despite strong headwinds such as the international economic climate and the high euro rate, Portugal is among the countries with the fastest growth in Europe.

Structural reforms

In the panel on structural reforms as the necessary levies for growth, **Guntram B. Wolff,** Director of **Bruegel**, remarked that a lot of institutional reforms have already been made and that a lot of necessary instruments are fully covered by the Treaty. It is politics that is the issue, and more precise the question of unanimity. Wolff pointed to the many divergences within the EMU countries: price divergences, labour productivity growth (with Italy lagging behind), the ease of doing business (strong improvement in Greece and Italy), wage flexibility… Furthermore, the growth performance in Europe is worse due to the delayed clean-up of banks and the wrong macro-economic policy decisions in 2011. Inefficient states are a big burden. The way in which fiscal adjustments are put together is central for growth and social acceptability.

Massimo Suardi, Head of Unit, DG Ecfin of the **European Commission** and responsible for the Spanish desk, acknowledged that the demand side is important also, but that there is a greater focus on structural reforms because of the structural shortcomings that are at the root of the crisis, the limited room for national policies and the spill overs. The differentiation between member states comes down to a polarization between peripheral countries and the core countries that are the best performers. The structural reforms have helped the convergence of countries like Portugal and Spain towards the best performers. The estimates of DG Ecfin say that thanks to structural reforms their GDP growth will be 3 to 4 % higher after 5 years and 5% after 10 years. That is why structural reforms play a prominent role in the EU coordination on fiscal and macro-economic policy and in the European semester. Spain has returned to growth, but the adjustment process is far from over.

Jorge Sicilia, Chief Economist of **BBVA**, added that Spain is not only recovering, its growth is even accelerating. Exports, savings and interest spreads have improved, and if this recovery proves to be similar to previous recoveries, job-creation will bring a positive surprise. Do not forget that all this was achieved without a currency depreciation. The real exchange rate was helped by a moderation in unit labour costs, so competitiveness gains are not merely temporary. Spain has improved the sustainability of its public finances and also of its competitiveness through the labour market and the tax system. Thanks to a supplier's payment program, liquidity has improved. The banking system has been restructured. But more has to be done in all possible fields such as fiscal policy,

competitiveness and the labour market because if Spain continues at the present pace, it will take until 2020 to reach the pre-crisis growth rate.

During the debate on structural reforms that followed, a lot of attention went to the fact that Spain still has a debt ratio of 100%. The heavy public sector and red tape makes Spain vulnerable. The present rate of inflation is too low for public debt, but also for private debt. Questions were raised on the political viability of structural reforms. The EU with its 28 member states has to undergo 28 political cycles. Reforms are only undertaken when politicians are forced by the markets. Some participants called this a scary perspective, others said the important thing is that at last politicians now do what they have to do. On the question if we can combine painful structural reforms with some form of economic support, several suggestions were made: to create confidence the policy program first of all needs to be convincing; the cuts in spending of the deficit countries should be supplemented by increased spending in the surplus countries; cutting taxes on labour might help; the quality of education is important; don not count on transfers because the four countries that got the most transfers needed a bailout.

Banking Union

In the second panel on the "Banking Union and the new regulatory roadmap as catalyzer for stability and growth" **Jose Leandro**, Principal Advisor on Socio-Economic Questions to **European President Van Rompuy** said that a Banking Union (BU) is a natural complement to the Economic and Monetary Union (EMU). The fact that this was not recognized at the start of the EMU was the cause of the problem. The capital inflows from surplus countries financed the rising disequilibrium of the deficit countries. One should not forget that behind every reckless debtor there is a reckless lender. To make matters worse, the capital inflows went to the non-tradable sector such as housing, giving rise to bubbles that were ignored by national supervisors. The BU with his homogeneous supervisory standers and single resolution mechanism brings this process to the European level, breaking the link between bank risks and sovereign risks. The BU will have other positive results too, because financial instability also has a price. Leandro reminded that the cost of non-intervention in Lehman was very high. The BU will bring about a further integration and consolidation of the banking market (already 600 banks have disappeared since 2008), a more important role of market financing vs. bank financing and a greater use of macro prudential policies and tools vs. micro. The BU is the most important step since the launch of the euro and it now has to be supplemented by a deeper coordination of economic policies.

Pablo Zalba, Vice-President of the **Economic & Monetary Affairs Committee of the European Parliament**, agreed that the BU can only produce growth if we go on with the rest of integration. For Spain, it was more important a few years ago to deepen its integration in Europa than to get a conditional bailout. Zalba claimed that Draghi did not save the euro, he only acted to give politicians time to save the euro. The lack of credit to small and medium enterprises is one of the biggest problems. The financial markets are still fragmented, so the last ECB measures are good. The BU will indeed be a catalyser for growth, but on the short term the positive effects only come from the renewed confidence. The BU is not enough, it needs more integration in a more democratic context.

Julio Durán, Director-General of the **Bank of Spain**, recalled that the causality of the crisis is still not clear. After the subprime crisis broke out in the American bank sector, Spanish banks were doing very well and were considered to be an asset to the Spanish economy. The crisis showed that the institutional setup was not appropriate, not that there was a lack of a single supervisor. When countries such as Spain and Italy gave up their currency for a new one, they did not realise that they, in fact, borrowed in a foreign currency. Assigning the single banking supervision to the ECB was a creative decision of which we will have to see how it evolves. The BU will be good for Spanish economic growth since spreads will disappear when Spanish banks will not lend to the Spanish state only. On the other hand the BU will force banks to find more capital and so hold back on credit, but this will temper the confidence that comes from the BU. Banking mergers will be more cross-border because the national concentration is already high. Finally Durán stressed that a simplification will be necessary in the wide number of supervisors such as EBA, ESRB and ECB.

Commissioner Almunia

At lunch, the keynote speaker was **European Commission Vice-President** responsible for competition**, Joaquin Almunia**. The priority for the EU is now to follow a growth strategy, he said. The adjustment of imbalances should be continued. Fiscal discipline has been strengthened but resolving the debt problem is a job that will take years. Further reforms in the financial system are needed. Almunia deplored that the core countries are making less efforts than the peripheral countries. It is true that the euro has contributed to the rebalancing of the periphery but the imbalances within have increased and the excess of savings in the surplus countries poses a problem that has to be corrected. Their argument “you want us to deteriorate our competitiveness” is not valid. There are still too many barriers to the single market that encompasses 28 countries, not only the 18 euro countries. An unused reservoir of productivity gains still exists on the labour market, the services market, digital markets, the energy sector. We are hindered by populists that use slogans such as “stop the Polish plumbers in France”. Also a lot of political barriers have to be cleared away. “Brussels” is the victim, it does not create the problem. Europe needs a macro-economic policy that revives the single market creating the necessary growth for jobs, the debt problem and expectations.

During the animated discussion that followed, ELEC President Bernard Snoy came back on the question of the North-South disequilibrium. Almunia said that while the borrowing countries stopped to borrow, the creditor countries still continued their surpluses, a situation that cannot be ignored. On Philippe Jurgensen’s remark that too many rules kill the economy, Almunia said that to combat the crisis, a certain amount of rules was

absolutely necessary. If unemployment in Spain shot up from 8% to 26% (and at this moment 25%) this had also to do with the bad functioning of the labour market. The weak supply of bank credit is also the consequence of the lower demand for credit. To Jan-Olaf Sipkes who deplored the indecision of the European Commission and High Representative Ashton, Commissioner Almunia answered that the Commission can only do things it is mandated for by the member states, e.g. the Ukraine.

Banking supervision

The third part of the conference was devoted to the new paradigm in banking supervision. **Ramón Quintana** of the **European Central Bank** described the structure and challenges of the new Single Supervision Mechanism that works within the ECB and that cooperates with the national supervisors in 18 countries. Its framework regulation came into force on May 15th, 2014. Its main aim is to restore confidence in the banking sector through an independent and integrated supervision in all participating Member States. In addition to the 5.000 national supervisors, it has its own staff of 800.

Francisco Uria, Senior Partner **in KPMG Spain**, said it was a good option to bring the SSM under the authority of the independent and profesional ECB. A close cooperation will be necessary between national and global supervisors. The supervisors should prepare for a brave new world that includes shadow banking, the global economy, high frequency trading etc. On the Asset Quality Review, Uria said that even in Europe there is a lack of minimal harmonization in banking regulation. In response to the remark of Nicole Scherf that the SSM might be under pressure to achieve quick wins and that it will need to show its teeth, Uria said the actual augmentation of capital by the banks even before the stress tests shows that the new system is already proving its impact.

The conference was concluded by a dinner in de Palacio de Viana in Madrid, offered by Mr. **José Manuel García-Margallo y Marfil, Spanish Minister of Foreign Affairs and Cooperation.**

Spanish foreign affairs minister García-Margallo talking to ELEC president Snoy and ELEC Spain president Gasòliba

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