

Miguel Fernández Ordóñez: The biggest risk - complacency

Address by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, delivered to the Círculo de Economía, Barcelona, 31 January 2007.

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I very much appreciate the opportunity provided to me by the Círculo de Economía to deliver this address at this time, just as the figures for last year have been released. In terms of the Spanish economy's performance, the figures speak for themselves and confirm a favourable short-term outlook. Against this background, I think it is very important to reflect on the underpinnings of the economy's trajectory, in order to identify those factors that are genuinely relevant for projecting ahead the progress that has been achieved in recent decades. I have therefore thought it best to adopt a long-term approach for this speech, going beyond conjunctural analysis. And with the title I have chosen, I have sought precisely to stress that when things are going well and the outlook is favourable, the biggest risk is complacency.

The year 2006 ended in Spain with growth at around 3.8%, outperforming the seven biggest industrialised countries. This is the first time in many years that this has happened. Not only has growth in Spain been higher than in the euro area countries, but it has also been higher than in the United Kingdom, Japan and the United States, which in recent years had been growing at a rate above Spain. Indeed, on these results, Spanish GDP is now ranked seventh among the industrialised countries, in front of Canada and only behind the United States, Japan, Germany, United Kingdom, France and Italy. Comparison with these seven countries can be taken as a basis to give us an idea of our strengths and weaknesses.

In terms of job creation, Spain was once again prominent in 2006, with a growth rate of 3.56%. That ranks us first among the big seven, and if we compare absolute figures (almost 700,000 jobs), no other country in the developed world has created so much employment, with the sole exception of the United States. Turning to public finances, Spain's end-year surplus also compares very favourably with the deficits posted in the other main developed countries.

Yet this should not hide the fact that we also ranked first in two unfavourable indicators. True, year-end inflation in Spain was 2.7%, below the figure of 3.7% the previous year and, of course, far below the level of 4% that marked the end of some of the high-growth years earlier this decade. But compared with the other seven major industrialised countries, Spain had the highest inflation in 2006. And likewise for the current account deficit. Our deficit in 2006 will no doubt be close to 8% of GDP, the highest figure among the big economies.

The Spanish economy has performed well against the backdrop of an expanding world economy and, most importantly for us, the firming of the recovery in the euro area. Global results in 2006 were once again surprising. World growth was around 5%, greater than expected at the start of the year, and inflation was contained, despite the persistence of a notable rise in oil prices. The country that most improved in the euro area was Germany, where growth rose from 0.9% in 2005 to 2.5% in 2006. The fact that Germany should have moved onto a growth path after so many years of sluggishness is undoubtedly of great importance for the prospects of the Spanish economy.

The optimism emanating from the booming international climate needs to be qualified, however. The world economy evidences certain problems and there are question marks about how hard or soft the landing of the US economy will be and whether the absorption of the balance of payments imbalances will be orderly or not. Furthermore, and above all, uncertainty looms over the level of asset prices following their high growth in recent years, in a situation of historically low long-term interest rates and exceptionally buoyant corporate earnings.

In the case of the Spanish economy, the ongoing expansion has been accompanied by the emergence of certain imbalances that pose potential risks to continuing economic dynamism. The Banco de España has reiterated that Spanish growth is being driven by resident spending that has not always been met with sufficient responsiveness in domestic productive activity; consequently, cost and price pressures have ensued. These have contributed to certain imbalances whose presence means that any potentially excessive optimism must be tempered. On the one hand we have the strong

growth of household debt, linked to intense house purchases in a property boom, and which is the other side of the coin of the high external deficit I referred to earlier. And on the other is the persistence of an inflation differential with our European partners, which raises doubts about the future behaviour of our competitiveness. The Banco de España has issued warnings about these risk factors and will continue to monitor them closely and analyse the attendant developments in depth.

Today, however, as initially stated, I should like to take advantage of the opportunity the Círculo de Economía has given me to take a longer-term perspective in examining recent developments in the Spanish economy and its future possibilities, moving beyond the usual short-dated horizon of economic forecasting exercises.

Looking back, we can see how favourably the Spanish economy has fared over the past 20 years, which is an incontrovertible fact. With the exception of the 1993 recession, which was fairly widespread in Europe, our country has been growing since 1986 systematically at or above the level of growth in other European countries. And since 1994 we have had 13 uninterrupted years of growth, with mild oscillations around a generally high average rate.

Spain's higher relative growth has many causes. Undoubtedly, the monetary policy of the European Central Bank, which has successfully achieved its objective of keeping euro area inflation and price expectations under control, has had a sharply expansionary effect on the Spanish economy. Indeed, lower interest rates have facilitated the growth of corporate and household debt and boosted spending and activity. But this cannot be identified as the sole cause behind our growth, and nor does it suffice to explain our better performance, since other southern European countries have also seen their financial costs substantially cut and yet have not recorded comparable growth.

Nor can there be many doubts about the favourable influence that the fiscal policies pursued since 1994 have had on economic agents' confidence. With the help of European funds, these policies have enabled the budget deficit to be reduced to the extent that, in the past two years, we have run a surplus. The beneficial effects of fiscal consolidation have been reinforced by the fact that the gradual elimination of the budget deficit has occurred without hardly increasing public spending relative to GDP.

Among the causes of the boom, we should also acknowledge the currency devaluations in the early 90s. These took place as a result of the turbulence then prevailing and led to a peseta-euro conversion rate that placed us in a very favourable starting position for the competitiveness of the Spanish economy.

To find a reasonable explanation for the continuous higher growth over such a lengthy period, it is not sufficient to point to the stability-oriented macroeconomic policies which, at least in the monetary realm, we have shared with other countries. We must also turn to the microeconomic reforms undertaken since the onset of democracy, encompassing areas as important as privatisation, the labour market and social security reforms, and the liberalisation of numerous markets; notwithstanding, as I shall indicate later, that there is still considerable work outstanding in this area.

An excellent example of these reforms is the transformation the Spanish financial system has undergone. Here, the efficiencies generated by liberalisation contributed to all players, in general, turning in a sound performance: bank and savings-bank managers, trade unions and employers' associations, governments and the financial supervisor all thus helped bring about an industry which is today held in worldwide esteem.

Nonetheless, although these macroeconomic and microeconomic policies no doubt brought their weight to bear, it would be very difficult to explain what has happened in Spain without turning to other more structural causes. One essential factor of growth in recent decades has been the change in the level of Spanish educational achievement in the 70s and 80s, which meant that those joining the labour market in the 90s had a far higher level of educational attainment than that of previous generations. And as well as higher education, these new entrants were also much greater in number than their predecessors. This indigenous population growth has been reinforced in recent years by the phenomenon of immigration, and has been an essential explanatory factor of our recent growth.

In addition to the foregoing causes, which can be quantified, there are others that are more difficult to measure since they refer to qualitative aspects, but which are equally relevant. Thus, for instance, Spanish trade unions have progressively adopted a bargaining strategy more in keeping with the requirements stemming from Spanish euro area membership and with the challenges posed by globalisation, and that has been conducive to employment generation and the growth of the Spanish economy in recent years.

Something similar may be said of the substantial continuity over time of the broad thrust of economic policy, irrespective of the different governments that have successively been in power. Such continuity has also impregnated the natural debate under democracy between the various policy options. Underpinning this debate has been a degree of agreement on the importance of stability-oriented macroeconomic (fiscal and monetary) policies and the microeconomic policies geared to improving the workings of markets. And this is not something that is found in all developed countries. Specifically, continuity in privatisation and market liberalisation policies, which has placed Spain in a leading position in continental Europe and has contributed significantly to the growth in the past 20 years, would not have been possible without this underlying agreement.

Whether this consensus is a result of the role played by Spanish economists, as Enrique Fuentes set out to demonstrate in his major work published by the Real Academia de Ciencias Morales y Políticas, will be something for historians to decide. I would, however, venture to say that in the economic debate in Spain heterodox positions, or those furthest removed from the central strand of current economic thought, are relatively marginal.

Concerning qualitative aspects, I have no doubt that another of the factors behind Spain's dynamism is the improved management of Spanish firms. And behind this lies a process in whose beginnings Barcelona was a driving force. I refer here to the expansion and quality of our business schools, which enjoy great prestige internationally. In the business school rankings of recent years, three Spanish institutions have systematically been in the top 30 worldwide.

I would not wish to conclude this review of the factors contributing to the momentum of the Spanish economy in the past 20 years without referring to the important role decentralisation has played. Decentralisation is not free from risks - and I shall in fact deal with some that are most relevant to us - but it has acted in Spain as a powerful economic, social and cultural dynamo, in a similar way to what happened in post-war Germany with the creation of the Länders.

Let us look now to the future. In the light of the trajectory of recent decades, what can we say about the future of the Spanish economy in the medium and long term?

To tackle the future from a useful perspective, I shall follow Epictetus's recommendation for gaining knowledge of the world. The stoic philosopher divided worldly matters into two: those that depend on us and those that do not. This classification is useful because, when talking about the future of the economy, it is worth focusing on those things that depend on the behaviour of economic agents and all those who intervene in framing economic, regulatory or supervisory policies, without wasting time regretting what we cannot change or influence.

Among the things beyond our control is, for example, the external environment, including the European economy which is so important for Spain, since our influence on developments in the rest of the world is very limited. It is also important to realise that the starting position of the Spanish economy with its strengths and weaknesses, which is the basis for predicting its short-term trajectory, is a given and we can do nothing to change it.

As indicated at the start of my address, I do not wish today to dedicate my time or yours to analysing the economic situation or predicting the course of the economy in the coming months. Rather, I shall focus on those determinants of the future of the Spanish economy in the medium and long run that really depend on the behaviour of all economic agents.

The first idea I wish to draw your attention to when contemplating the future is that the favourable results of the Spanish economy in the past two decades cannot be attributed to a single cause; rather, they are due to a host of reasons. Accordingly, if we wish a similar performance in the coming years, we shall have to tend to the overall block of favourable factors we have enjoyed in past years and not believe that a simple repetition of one of the recipes applied may suffice. That is all the more relevant bearing in mind that some of the impulses in the past - such as those stemming from devaluations or from European funds, for instance - will not come round again.

In my opinion, those who say we should focus exclusively on sound fiscal policies are mistaken, as are those who believe wage moderation will suffice and those who think that it is enough simply to continue pushing through structural reforms. I believe any partial approach is erroneous. We must look to all the fronts. If our fiscal performance or the labour climate worsens, if the consensus on the broad thrust of economic policies I referred to earlier is broken, or if we bring structural reforms to a halt, it will not be possible to maintain favourable results in the future.

True, having joined the euro area, some sources of instability have disappeared. The volatility of key variables for economic agents such as the interest rate, inflation or the exchange rate has diminished. But growth has continued to be unbalanced in those aspects I have already mentioned, such as household and corporate debt, and continuing price and cost differentials. At issue here are imbalances posing risks to growth sustainability within an area with very high stability requirements by Spanish standards.

Yet while such risks are very important for the Spanish economy, the biggest risk of all is complacency. It is vital to maintain the attitude of non-complacency which has driven economic agents, governments and other players who have sustained the Spanish dynamism of recent decades. A change in attitude which were to convert the satisfaction with the current situation into an excuse to detain the drive to innovate and reform would, sooner or later, bring the ongoing process to a halt. We must continue striving to discover how we can improve the performance of our institutions and companies. This is the main idea I wish to share with you today: let us not fall into complacency. However much we have progressed, let us not stop. There are examples of developed countries which, having achieved very favourable income and wealth levels, lost their reforming dynamism and, as a result, entered lasting situations of slackness and sluggishness with serious employment problems and a deterioration in confidence at all levels.

It is therefore important to identify the specific policies we should foster in the future. With monetary policy now transferred to the European Central Bank, the policies left to us are fiscal and structural ones. And if I were to be consistent with the recommendation I made to watch over all fronts, I ought now to give an exhaustive list of each and every economic policy. But as Madame du Chatelet's friend said, "The secret of being a bore is to tell everything". Thus, out of respect for you, I shall choose only what I consider to be most significant in the fiscal and structural field.

Structurally speaking, while the loss of competitiveness is one of the risks looming over the economy, the boosting of productivity should remain the driving principle of all reforms. The National Reforms Programme, as indicated in the Banco de España *Annual Report* last June, duly includes the liberalisation and market flexibility policies the Spanish economy needs. It is now a question of adhering to it. The programme provides for very important liberalisations such as those of the railway and energy sectors, which have so often been put back. If they are diligently and ambitiously rolled out, they could contribute effectively to the growth of the Spanish economy. The gearing of public spending towards infrastructure and investment in Research, Development and Innovation should also be maintained.

Promoting an environment that is more conducive to both the creation and closure of companies would be a very effective means of modernising the Spanish economy, since it could provide the measures of flexibility and adaptability that are needed to compete amid the pressures generated by globalisation and to boost the incorporation of technological and managerial innovations. But of all the structural policies, the most important is undoubtedly education. As I have said, the educational and training drives of the past decades are largely responsible for the results achieved by the Spanish economy, and improving education and training today is, once again, pivotal to our future growth.

When assessing the functioning of the economy, we often refer to differentials with other peer economies in terms of inflation, productivity and many other variables. And it is right to do so since, against a backdrop of international openness and integration, relative behaviour and, in short, competitiveness are essential for the continuous improvement of well-being. However, the most serious gap between Spain and the other major industrialised countries is in the field of education. True, we have improved in this area in recent years. The proportion of the population aged 25-64 with a secondary education has risen from 24% in 1992 to 48% in 2005. But we have yet to reach 50% when the figure is 83% in Germany, 72% in the United Kingdom, 66% in France and over 80% in the Nordic countries. Conceivably, these differences might be heavily influenced by the relatively recent nature of our educational development; but looking at the percentages for young people in the 25-34 age group, it can be seen that, despite the progress recorded, a gap exists which, though moderate (64% in Spain compared with figures of over 80% in most of the major countries), remains illustrative of our continuing laggardness.

In the current decentralised State, the central government retains few responsibilities in respect of education, which means that educational progress in Spain is fundamentally in the hands of the regional governments. These may thus be said to have a major responsibility in determining our long-term growth prospects and the future functioning of the Spanish economy. And this conclusion is further reinforced when considering the changes that have come about in budgetary policies. Hence,

insofar as the decentralised structure of the State has played a very positive role in growth in the recent past, as I said at the start of my address, when speaking of the future it emerges once again as a determinant of the first order. As is known, public spending by territorial governments is more than two and a half times that of central government. It is clear from this that what regional and local governments do is, for the purposes of maintaining the public spending/GDP ratio, much more important than what central government does.

The Budgetary Stability laws have taken this essential change in the structure of the State into account when establishing the budgetary discipline rules. And to date the stability objective has been reasonably met. But this is an area where we cannot lower our guard. As I have said, one of the advantages behind Spain's growth differential when compared with other European countries is the fact that our public spending/GDP ratio is below 40%, while in other countries it is close to or exceeds 50%. The need to maintain this comparative advantage must be clear. And this means that when public demands for education and health care exert pressure on territorial governments, especially at times when the growth of revenue is not as high as it currently is, it will be necessary for increases in education spending, which are so important for growth, to be offset by cuts in spending intended for other less priority areas. As regards health care, it should be recalled that there is extensive potential for improving management, potential which we must harness. It is important to bear in mind the experiences of other European countries that opted for a model of increasing public spending on health but which, nevertheless, did not attain the desired results.

Decentralisation has accounted for much of our strength in recent decades and growth in the coming years will depend greatly on which direction we take. Employers, for instance, have recently issued a warning about the potential impact of decentralisation on certain regulatory aspects affecting market integration. The example of Germany's economic history in the 60 years since the Second World War, which may very briefly be described as 40 years of vigorous expansion and almost 20 years of sluggishness, should be food for thought when extracting all the strong and favourable aspects of decentralisation and avoiding those phenomena entailing risks to the efficient working of the economy, on which any lasting improvement in well-being ultimately hinges.

Finally, another policy area to which great heed should be paid when seeking to sustain healthy public finances in the medium and long run is that of Social Security. Admittedly, the forecasts available denote a lack of major problems in the Social Security system in the coming years; however, looking further ahead, it is clear that if changes are not made, the system may become a considerable deadweight holding back growth in the Spanish economy. When the long-term consequences are taken properly into account, it is fairly clear that the sooner Social Security reform begins, the less costly it will be. Or stated the other way round, if Social Security reform continues to be delayed, we may find ourselves faced with a truly dangerous dilemma: either changes are undertaken that will have to be more drastic and may be traumatic in some respect, or otherwise growth in the Spanish economy will be seriously impaired.

In sum, on viewing recent developments in the Spanish economy we can draw a positive assessment that should not disregard the accompanying imbalances. And from a broader medium-to-long-term perspective, we also see encouraging potential that likewise merits a favourable judgment. However, in order to project ahead a positive growth differential relative to the prevailing pattern in the industrialised countries, we must not lapse into complacency and must keep reform firmly on the agenda. Evidently, reforms will have to be different from those adopted to date, but should be based on a similar philosophy: to maintain fiscal soundness against a background of macroeconomic and financial stability, to push ahead with liberalisation and market flexibility, and to give weight to education and training. If I had to opt for just one of these messages, highlighting what I consider to be the main task needed to anchor the dynamism of the Spanish economy in the long run, I would not hesitate to say that it is to improve the levels and quality of education.

Thank you.