

## **Miguel Fernández Ordóñez: Recent developments in the Spanish economy**

Testimony of Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, to the Parliamentary Budget Committee, Madrid, 9 October 2007.

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Ladies and gentlemen,

My appearance before this Committee as part of the Parliamentary discussion of the State budget for 2008 comes at a time when shocks are still reverberating through some of the major international financial markets, and the attendant uncertainty inevitably bears on the analysis of the economic situation.

In my appearance before the Parliamentary Committee on Financial Affairs on 17 September, I examined in detail the origin and the main implications for ECB monetary policy and for the Spanish economy of these shocks, which emerged last summer against a background of marked momentum of the economy and of world trade.

A significant part of this dynamism – reflected in growth rates above 5% for world output and above 6% for trade – derives from the sound performance of the emerging economies in recent years; indeed, they seem to have been less affected by the shocks than the more developed Western economies. This is, in fact, a significant feature of the present bout of turbulence which, if I may briefly recall, originated in a financial market of a developed country (the US sub-prime mortgage market). The turbulence was initially transmitted to other international financial markets through sharp corrections in the credit quality of certain complex structured financial products which, at least apparently, were relatively concentrated in the financial systems of a number of developed economies. The Spanish economy is not one of them. Although I will pass quickly over this point, which I addressed in depth in my recent appearances before Congress and the Senate, I do wish to remind you of the safety buffer afforded by the Spanish financial system's non-exposure to practices and products of this type and by the soundness of our credit institutions in terms of profitability, solvency and ample provisions.

In the economies most directly affected, credit institutions active in originating and distributing these complex structured products have prompted tensions in the interbank markets in which the liquidity provided by central banks to the financial system is redistributed. The rapid response of the central banks, led by the US Federal Reserve and the European Central Bank, prevented these tensions from acting as a channel through which the instability was further amplified. We must acknowledge, however, that there are still uncertainties hindering the normalisation of these markets and that dissipating them will require an additional effort by institutions to increase the transparency of their operations.

The euro area stands ready to face these shocks from a solid position and, therefore, with significant resilience. That said, in the second quarter of 2007 the euro area's GDP grew less than expected, although it held at levels in line with potential growth.

The fundamentals underlying this growth pattern remain firm, so conditions are generally favourable for the continuation of the current economic boom. Significant in this respect is, firstly, the favourable trend of employment, which is a necessary, albeit not sufficient, condition for the increased buoyancy of private consumption in the area. Secondly, European firms on the whole enjoy a healthy financial position and are posting substantial profits, a situation which is conducive to the growth of private productive investment.

In the external sector, however, most of the available forecasts point to a loss of steam in the US economy in the coming quarters. But this will be countered by the continued thrust of the

emerging economies which, as stated, are showing notable resilience to the type of financial tensions currently at large.

The sound economic performance of the area has, moreover, been compatible with continued low inflation rates. The rise evidenced by the September figure – which will probably continue in the closing months of this year and in the opening months of 2008 – is largely attributable to the more volatile components of the HICP. Firstly, it is strongly influenced by energy prices, which in the closing stages of 2007 are unlikely to repeat the favourable pattern of late 2006, so the growth rate of the HICP is being subjected to an upward base effect of some size. Secondly, the demand pressures and decreased supply in the markets for certain food products are exerting upward pressure on the prices of those products.

This is, in short, the macroeconomic situation of the euro area as it faces the financial market shocks. The time elapsed and the information it has been possible to gather since the summer are clearly insufficient to predict with any accuracy the most likely effects of this turbulence on the European economy in the medium term.

Before July, the persistence of the global imbalances and of protectionist pressure in some markets, the uncertainty over the future behaviour of oil and commodity prices, and the pressure that more buoyant employment might exert on wage demands made for a scenario in which the balance of risks to euro area activity growth and price stability was moving downwards in the first case and upwards in the second.

Subsequent events in international financial markets since then suggest an increase in downside risks to activity, which may have mitigated to some extent the risks to price stability, which continue to be upward. However, uncertainty is still very high in relation to at least three factors that may be crucial for the outcome of this bout of turbulence.

First, more information has to be gathered to determine more accurately the extent of the US slowdown and its possible transmission to the world economy. Second, the ultimate effects that the upward revision of credit risk premiums will have on the cost and availability of private sector financing will have to be determined. These premiums had reached very low and, in general, scantily discriminatory levels in recent years against a background of widespread optimism and economic boom, and so may have led to probably excessive investment in certain potentially high-risk activities. Such a revision is, in itself, a healthy sign, but it is yet to be seen how large it will be and whether it will be orderly, as would be desirable. Also, the significance, and the impact on European corporate and consumer confidence, of the poor functioning of some markets will largely depend on how long this bout of turbulence lasts.

Against this backdrop of uncertainty, on 4 October the ECB Governing Council decided to hold official interest rates unchanged, reiterating its commitment to price stability, close attention to ongoing developments and readiness to act as necessary to prevent the risks to price stability from materialising. At the same time, the ECB has expressed its determination to use the resources available to it to smooth the process of normalisation of European interbank market conditions.

As I mentioned before Parliament scarcely a month ago, these events come at a time when the Spanish economy continues to show considerable buoyancy, with GDP growth in the first half of the year around or slightly above a rate of 4% and employment growth somewhat higher than 3%. This period saw the continuation of the slight moderation in domestic demand first seen in 2006 and of the improvement in the contribution of net external demand to growth, which began that same year, enabling the composition of domestic and external sources of expenditure to be brought more into balance.

But the change in composition extended also to domestic demand, where lower relative household spending growth and stronger business investment were observed during the first half of the year. Indeed, the gradual moderation in household consumption initiated some

quarters ago continued, reflecting a natural adaptation to less generous monetary and financial conditions as a result of the interest rate rise under way since late 2005 and of the weaker wealth effect on consumption due to slower house price rises. However, the buoyancy of employment and its effect on income prospects are helping to smooth the adjustment of consumption to more sustainable levels.

It is precisely this behaviour of employment, which continues to be underpinned by considerable demographic dynamism that is the main factor behind the gradualness of the first-half slowdown in residential investment, since also in this case the higher interest rates and the lower expectations of capital gains are making for less vigorous housing investment. The change in monetary and financial conditions also induced a certain moderation in their demand for credit, contributing to a progressive stabilisation of household debt ratios.

Corporate investment and borrowing plans are being affected somewhat less perceptibly by the rise in interest rates. Particularly notable is the continued strength of productive investment in a situation of high profitability and favourable business expectations. In fact, it has become the most buoyant component of domestic demand, although moving on a mildly decelerating trend in the second quarter. Also apparent in the last few months is an incipient change in the purpose of loans extended to firms, with a slowdown in those used to finance real estate and construction activities, and an increase in those to industrial firms.

Net external demand is helping to mitigate the impact of slower spending on growth, mainly due to the moderation in imports in the first half of this year, probably in response to the mild slowdown in final demand. Meanwhile, exports, after the good results last year, are showing the effect of more contained world – and especially European – growth and perhaps the effect of the euro's appreciation on sales to non-Community countries. Spain's net borrowing, although it has continued to increase, is doing so more slowly than in previous years.

The changes I have described in GDP composition on the expenditure side have been feeding through to the various productive branches which, as a whole, have remained most robust in the first half of this year. Noteworthy in this respect is the strength of industrial production and the mild slowdown in construction activity.

But the most notable feature on the supply side was again the abundance of labour resources, which continue acting to smooth the adjustment of activity to the buoyancy of demand, preventing cost pressures and excessive prices. The growth of consumer prices, spurred by a temporary turnaround in oil prices in the first half of the year, posted a year-on-year rate of 2.2% in August, leaving the differential with the euro area close to its historical low. However, it is very likely that, once the base effect of the energy price falls in the closing months of 2006 has been stripped out, inflation will again rise and that at the end of this year it will reach levels similar to those at end-2006. This is in fact suggested by the HICP growth flash estimate of 2.7% for September.

In examining the outlook of the Spanish economy for the coming quarters, it has to be kept in mind that there are still few indicators of the situation since the turbulence erupted on international financial markets. Nonetheless, the available information indicates that the profile of smoothly moderating activity apparent since the second quarter continued in the third quarter, and this pattern can be expected to persist throughout the rest of the year, with scant deviations from the forecasts published by the Bank on 30 March (3.7% for 2007). This slight slowdown is based on domestic demand and, more specifically, on the consumption and residential investment components, while the contribution of net external demand to growth in the first half of 2007 improved further. The slowdown in GDP seems to point to a gradual shift to a growth rate of around 3% in 2008 as a result of some rebalancing of the domestic and external sectors. However, the shocks affecting the international financial markets since August have also increased uncertainty over the forecasts for the Spanish economy and have possibly heightened the downside risks.

Allow me to spell out some of the factors behind this scenario of a smooth slowdown, compatible with continued highly dynamic activity and employment.

First, the change in monetary and financial conditions will foreseeably ease the adjustment to a more sustainable pace of private-sector spending and indebtedness. This adjustment started some time back and is proceeding smoothly. Second, the progressive normalisation of the real estate market, against a background in which the demographic factor and the buoyancy of employment are lending greater support to housing demand than in previous property cycles, would limit the effect of slower house price rises on consumption and soften the impact of the cyclical change on residential investment.

At the same time, the step-up in private- and public-sector investment in recent years has raised the level of capitalisation of the economy following a prolonged period of intense job creation, and this should manifest itself in higher long-term potential growth. Although it is unlikely that the expansion of business investment and non-residential investment in construction will maintain the pace of recent quarters, the growth outlook for both spending components is, at first sight, favourable.

In any event, it seems unlikely that productive investment alone can offset the lower contribution from household spending. Hence, as I pointed out in my previous testimony, the role of net external demand will be fundamental in making some containment of spending compatible with a continued growth rate of around 3%. As we have seen in the last few years, the contribution of this variable to growth depends very much on the performance of Spain's export markets, but also on the competitiveness of Spanish production. Therefore, a scenario of recovery in net exports such as that described requires Spanish firms to push ahead with the improvement in competitiveness made by them in response to the sharp ongoing adjustment in the structure of world trade due to the entry of new competitors. At the same time, the slower momentum of final demand should manifest itself in a certain slowdown in imports, curbing the leakage of spending out of Spain.

However, as I indicated in September, it is precisely in the external economic environment where the main factors of risk to the macroeconomic scenario outlined above are to be found. If the recent bout of financial instability and of heightened international uncertainty were to significantly affect the buoyancy of Spain's export markets, the capacity of external demand to contain the adverse impact of a slowdown in domestic spending would be diminished and, accordingly, the efforts required to improve competitiveness would be even greater.

Domestically, the continued dynamism of employment and the gradual normalisation of the property market are fundamental for keeping income expectations and, consequently, agents' spending plans on a mildly slowing course. In any event, the Spanish economy is witnessing a process in which construction investment is diminishing in importance as the engine of growth. Therefore, it is essential to have a sufficiently flexible mechanism of resource allocation to enable industrial activity and services to take over from construction, furthering the change in output composition that has been taking place in the last few quarters.

In the current circumstances, economic policies have an important role to play by holding the euro area firmly on course to meet its macroeconomic stability objectives, which are those that make sustained growth possible and shore up the economy against shocks and outbreaks of insecurity and uncertainty. As mentioned above, the main task of monetary policy is to ensure euro area price stability in the medium term, and it is against this background that monetary conditions have gradually been normalised since December 2005. This process has been correcting the benign monetary conditions of the Spanish economy in recent years and promoting a more balanced growth pattern.

The most valuable contribution fiscal policy can make is to ensure the commitment to budgetary stability. This commitment has been essential for establishing the conditions propitious to the recent long period of economic growth of the Spanish economy and it is particularly relevant to the macroeconomic setting I have described.

The latest official forecasts for the general government account are for a surplus of 1.3% of GDP in 2007. This would amply meet the requirements of the Stability and Growth Pact and enable a further reduction of the public debt/GDP ratio. Moreover, it represents an improvement of 30 bp on the target set in the latest update of the Stability Programme. This improvement basically reflects a positive deviation of tax revenue with respect to budget, in a setting of higher-than-expected growth.

The target set in the draft State Budget for 2008 for the general government surplus is 1.15%, in a macroeconomic scenario characterised by a mild slowdown in GDP. The projected decrease in the surplus is based essentially on tax cuts mainly affecting personal and corporate income tax, whereas on the spending side the draft Budget sets a growth rate for the State in line with expected nominal GDP growth. This entails strict compliance with the ceiling established in the Budget Stability Law in June.

In any event, it should be kept in mind that the Budget is based on a projection for end-2007 that is very prudent on the revenue side. The strong buoyancy of receipts in the year to date, particularly in direct taxes, might enable the latest official projection of the surplus for 2007 to be exceeded. Should this occur, under a macroeconomic scenario similar to that assumed in the Budget, this improved result in 2007 should be carried over to the budget for 2008 and thus enable another surplus in excess of projections. What is most important is that, as in previous years, the additional revenue that may arise should not lead to increased spending, but rather to a higher surplus.

Regarding the size of the budget surplus, I wish to underline that the current situation of public finances is, in part, temporary. This is because, after ten years of rapid expansion at a rate that has recently exceeded potential growth, the actual buoyancy of tax revenue has naturally been associated with the buoyancy of domestic demand and, in particular, with the vigour of the real estate sector, and therefore has a temporary component that would tend to disappear in an economic slowdown. It is therefore imperative to preserve the stabilising potential provided by the current state of public finances so that phases of less dynamic private spending can be faced with strength and the ability to react and, above all, so as to be prepared for unexpected contractionary shocks. This approach is especially valid in the current climate of uncertainty, in which a continued economic policy of rigour and budgetary stability is one of the most valuable resources when it comes to preserving internal and external confidence in our economy.

Perseverance in the strategy of budgetary consolidation is also necessary from a medium-term perspective so as to be in the best possible position to address the foreseeable impact of population ageing, aside from the required further progress in reform of the pension system.

Regarding the co-ordination of this strategy, I would like to add two more comments. First, it is very important that all tiers of government contribute effectively, particularly the regional governments, whose weight in public spending policies has become most substantial. However, the official forecast is that, overall, these territorial governments will still post a deficit in 2007 despite the benign economic circumstances over the last few years.

Second, budgetary stability should be accompanied by an improvement in the quality of public finances to secure advances in the allocation of factors of production, particularly human and technological factors, and in the efficiency of the economy. The spending policies included in the draft Budget give priority to areas of key importance for improving productivity, such as increased resources for research and development, education and infrastructure, although other priority items entail increases in current primary spending. It is important that the envisaged increase in resource allocation be managed efficiently through the use of better suited mechanisms to assess and select public policies so as to enable real increases in productivity.

The budget is not, however, the only instrument, nor often the most appropriate one, to achieve the aim of raising the efficiency of the economy. Structural policies designed to make

factor and product markets more flexible will be called on to make an essential contribution to this aim and, for this purpose, it is necessary to persevere with and extend the processes of liberalisation undertaken in recent years. Policies of this type, which enable growth potential to be raised and make for the efficient allocation of resources in the economy, are pivotal in the present conjuncture, which, as stated earlier, requires a rebalancing of the sources of growth of the Spanish economy.

Thank you.