

## **Miguel Fernández Ordóñez: What should be done during the macroeconomic adjustment phase in Spain?**

Speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at a Lunch-conference organised by El Correo de Andalucía, Seville, 25 September 2008.

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Since August last year the world's developed economies have been convulsed by two very severe shocks: the rise in oil and other commodity prices and the outbreak of financial turmoil that has reached dimensions that nobody could have imagined initially. The increase in commodity and oil prices seems to be easing, and yet the events of recent weeks suggest that, as regards the turmoil, we are probably experiencing the most significant financial crisis since 1929.

There are already numerous reports by domestic and international agencies (IMF, OECD, Bank for International Settlements) analysing the causes and consequences of the situation the industrialised economies are currently going through. At first it was thought that the repercussions of the financial crisis would be concentrated in the US economy. Then it was considered that other industrialised economies in which debt, the external imbalance or the property boom may have been important, like the UK, Spain, Ireland and New Zealand, might also be affected, while other countries would remain beyond the contagion. But this has not been the case. The effects have reached all countries. As we have just seen with the release of Q2 European growth figures, countries with large external surpluses such as Germany, have also posted a very weak economic performance. As a result, today, unlike a few months ago, nobody is defending the possibility of certain European economies decoupling from what is happening in the United States.

As you can imagine, the Spanish economy has not been able to remain unaffected by these processes. In fact, our country, which had been building up certain imbalances, in the form of rapid growth of household and corporate debt and, consequently, of a large external deficit, had already embarked upon a smooth correction from mid-2006. However, global events have accelerated and intensified this adjustment, even though, from the viewpoint of the financial system, Spanish banks have had absolutely nothing to do with the causes of the financial crisis. They have not generated doubtful assets like US banks have, nor have they invested in these assets like many European Banks have. However, the financial crisis has not only affected the institutions that generated these toxic products or invested in them but, by inducing financial market breakdown, has spread to all institutions. For Spain, this means that the adjustment process must now take place in the presence of much more difficult conditions in the financial and international environment than we have enjoyed during the last decade.

That said, the Banco de España has pointed out on a number of occasions that some of the adjustment we are experiencing is an inevitable part of economic developments, which will allow correction of the imbalances that had been accumulating during the upswing. Indeed, their continuation would have entailed an increase in the vulnerability of the Spanish economy and the eventual correction would have been even more severe. Cyclical upswings followed by downswings are a normal feature of all economies, although the fact that Spain has recorded high growth rates without interruption for fourteen years may have led agents to forget the existence of this type of cyclical disturbance.

Before addressing the central theme of my speech, it would be useful to answer the question why the industrialised countries have suddenly found themselves in such a complicated situation. Part of the answer (the other part being the regulation and supervision failures in many countries) relates to the strong increase in corporate and household debt in numerous countries in recent years, which led, in the presence of highly favourable financial conditions,

to a significant appreciation in the value of financial and real assets. Some economists and institutions have argued that monetary policy was too lax and that central banks should in future pay attention not only to inflation, but also to other financial developments, such as credit, when taking their decisions. In some cases, these favourable financial conditions were harnessed to expand residential and productive investment (as in Spain), while in others consumption was also boosted by the ready availability of financing, leading to a spectacular reduction in household saving ratios, as in the United States. The excessive financial expansion was also accompanied by a reduced perception of risk by investors and intermediaries, contributing to spending growth and the leveraged buyout boom. This situation was gradually changing as central banks tightened their monetary policy, but the most radical change took place from the summer of 2007, when the turmoil led to a rapid and substantial reassessment of the risk of financial instruments and a sudden standstill in many segments of the money and capital markets. There then began a process of deleveraging, the opposite of the one that took place in the previous years of this decade, in which debtors are striving to rebuild their balance sheets, while investors exercise the greatest prudence in choosing where to place their savings.

During the stage of strong credit growth, the Spanish economy accumulated certain imbalances, linked to the fact that (residential and capital) investment exceeded national saving. However, Spain has preserved a number of very important stabilising factors, such as the balanced budget, to which I will refer later. Also, as I have mentioned in detail in other speeches, Spanish banks were not involved in the financial innovation operations that, through the creation of highly sophisticated instruments, lie at the source of the current financial crisis. This means that our institutions are in a somewhat more solid position to face the new stage than those of other countries.

Today I am going to reflect on what I consider that different economic agents should do during a macroeconomic adjustment phase like the one we are currently experiencing in Spain. It seems to me that it would be useful for us all to understand what is happening and what we can do to get through this phase at the lowest possible cost. Admittedly each agent has a different degree of freedom of action, but it is important to remember that it is not only the authorities (governments, parliaments, the ECB, etc.) who can help our economy to return to a high growth path as soon as possible.

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To start with, I should like to point out that the most important thing is not to fall into the temptation of adopting policies that try to avoid the adjustment, since that would only prolong it and prevent the economy rebuilding the foundations for fresh growth.

It is understandable that firms for which oil is an important input should appeal to governments to reduce the cost of energy through some mechanism, such as subsidies or lower taxes, as likewise it is understandable that businessmen and financial institutions that can no longer obtain low-cost, long-term funds on the market think that the State could provide them with larger volumes of financing and on better terms than the market. It is vital that governments and parliaments reject these temptations, not only because of the possible budgetary repercussions, but also because it is essential that economic agents adapt to the new realities, however painful these may be. This is even more important when these realities, like the price of oil and the availability of funds on international financial markets, are global phenomena that even countries larger and more powerful than our own have been unable to influence.

Thus, the aim should not be to isolate the Spanish economy and protect its agents from the various shocks that we have suffered in recent quarters, but rather to facilitate the adjustment process, permitting changes in relative prices (energy, labour costs, mark-ups) and the reallocation of resources across sectors to take place with a high degree of flexibility.

Another approach that must be ruled out is short-termism. In general, economic policy should be designed in all situations from a long-term viewpoint, because many important measures

(I dare say the most important) are structural, and these are the ones that tackle the economy's fundamental problems. It is understandable that, when faced with a stream of bad economic news, like at present, public opinion calls for rapid reactions and that the temptation to focus on short-term measures increases. Such proposals are also based on the idea that structural measures only have medium and long-term effects, and are therefore inappropriate for a period of economic weakness. This is not true. Evidence shows that, apart from their medium-term effects, structural reforms may have significant favourable effects in the short term, in so far as their introduction may make agents more confident that the foundations for growth are being made more solid and flexible. Such an improvement in expectations may also help to bring forward certain spending decisions, such as investment projects aiming to exploit the new opportunities that these structural changes may give rise to in the future.

Now is therefore the time to stress the essential role played by the institutional framework and policies that provide incentives to facilitate economic adjustment. In this respect, as I have already mentioned, obviously not all agents have the same degree of responsibility when facing a period of difficulty, the authorities being the main agents responsible for shaping this combination of positive incentives. Given that the decisions of the private sector (households and firms) depend significantly on the institutional framework and incentives, their role in the adjustment (especially that of households) is highly constrained by the framework in which they operate.

This is perhaps the main thing that the authorities should take into account in their response to a period of economic difficulties, both when managing budgetary policy and when designing their regulatory and market-organisation policies. It is necessary to analyse, at all times, whether the policies proposed provide the appropriate incentives for agents to adapt to the adjustment, increasing the probability that the economy will return to a growth path in the medium term.

In the case of monetary policy, it is essential that it should be completely geared to the ECB's mandated objective of keeping inflation at very moderate levels, and in this respect I think that the ECB is fully complying with its task. It would have been very negative if the European Central bank had fallen into the temptation of forgetting its objective of containing inflation, attempting to alleviate the painful adaptation by households and firms to the very substantial increases in commodity and oil prices that we have experienced. Fortunately, there is complete confidence that the ECB will ensure that inflation returns to its target level, and this is helping to somewhat reduce the uncertainty surrounding the financial system, growth and other variables.

In the case of budgetary policy, one positive element of the Spanish case is its favourable starting position. This is based on the notable budget surpluses recorded in recent years and on the sustained decline in the ratio of government debt to GDP to 36%, a very low figure in comparison with other developed countries. This initial situation has made it possible for automatic stabilisers (i.e. the reduction in revenues due to the slowdown and the increase in spending on unemployment as a consequence of the rise in the numbers of unemployed) to be allowed to operate freely, providing a significant counter-cyclical component in the adjustment phase. Moreover, this good starting point has, for example, avoided the need to react to the current losses of revenue by raising taxes, which would have certainly magnified the intensity of the adjustment. That said, the slowdown in spending is having a significant impact on tax revenue, reducing the budget balance very rapidly, so that utmost prudence must be exercised in fiscal and budgetary decisions.

The need to provide the appropriate incentives means that it is advisable not to adopt widespread and permanent discretionary budgetary measures that attempt to counter the effects on households and firms of the inevitable reduction in national spending required by the adjustment process. Measures to increase spending would, at best, enable activity to be sustained only temporarily and would not help to improve the prospects for expansion in the

medium term. And I say at best because, without an improvement in external competitiveness, a large part of the increase in public spending would leak abroad and have only a minimal impact on domestic activity.

Likewise, strengthening control over current general government spending is an essential measure in response to a low-growth phase, since it limits the deterioration in the budget balance, signals stability and rigour to the private sector, and provides greater leeway to undertake public investment projects that enable the Spanish economy's productive base and competitiveness to be enhanced.

It should also be remembered that, since the bulk of public spending, including investment, is carried out by regional and local government, the behaviour of these authorities is going to be decisive in determining the general government contribution to weathering the adjustment.

In the case of the Spanish adjustment, moreover, a shift in productive activity is required. It seems obvious that the relative size of the construction sector, following its strong expansion over the last decade, is going to be reduced, while other activities need to fill the gap. To facilitate the reallocation of resources of all kinds (human, financial, technological) entailed by this shift in output, it is essential that goods and factor markets should have a flexible and competitive structure. Thus, in a period like the present one, it is fundamental to review the situation of these institutions and to explore the scope for undertaking structural reforms to make the economy more flexible, liberalise sectors and markets and increase competition, so that resources can be used optimally.

Despite the efforts made in recent decades, there are still a number of areas of the Spanish economy in which these reforms continue to be very necessary. The high inflation rates recorded for some components of the consumption basket and the large mark-ups observed in certain activities underline the need to enhance the competitive environment in certain segments, such as goods distribution and services provision. The transposition of the Services Directive is an opportunity to boost competition in this sector that must not be missed. Lower inflation rates would not only favour the competitiveness of our economy, which is so vital at a time when national spending is slowing, but would also improve household purchasing power against a background of declining household income on account of the oil price shock and the slowdown in employment. There are many other fields (such as the postal service, railway transport, ports, airports, energy, etc.) in which structural reforms giving a greater role to the private sector and competition need to be adopted as soon as possible.

As I have already mentioned, the residential sector clearly needs to slim down and it has been doing so quite rapidly in recent months. The rise in uncertainty regarding both the economic outlook and house prices is inhibiting residential demand, even though household creation, due to the increase in the population and the observed tendency for average household size to decline, is still growing at significant rates. Improving the regulation of rented housing, to make it more flexible, profitable and attractive, would enable the demand for residential services from those who do not wish (or are unable) to buy to be met and would reactivate that part of the demand to purchase housing that basically stems from the investment motive, thus reducing the current excess supply in the market.

In particular, providing legal certainty to home owners and deregulating the rental periods that may be agreed by tenants and landlords would boost the rental market. Since in recent years a part of household wealth has taken the form of property investments, if the number of houses used to generate funds through rental could be increased, it would also help many owners to meet their debts.

A third area in which reform is fundamental is the labour market. The performance of this market will probably be the key to determining whether the current adjustment will be rapid and slight or whether it will be prolonged and far-reaching. It is often said that the Spanish labour market is very flexible, and the evidence cited for this is the high proportion of

temporary workers. Indeed, the existence of a relatively high proportion of temporary contracts may mean that some firms have a greater capacity to respond to changes in economic conditions, but these contracts are not evenly spread across sectors, nor would they seem to be conducive to the proper training of workers. Moreover, the idea that the labour market is flexible because it allows the burden of adjustment to fall on temporary workers is hardly equitable, since it means that a very specific group (generally the last entrants to the labour market) bears the main burden of that cost.

However, as I noted at the beginning, it is of interest to explore decision-making areas other than that of the authorities. Firms are the basic economic agent, since they take most of the economy's production decisions and their management, strategy, adaptation to demand and use of resources ultimately determine the economy's growth rate, productivity and competitiveness abroad. Given the weak national demand with which they are faced, firms will evidently give their utmost attention to managing their productive processes efficiently. In particular, the surge in oil prices will force them to review the energy consumed in production. Although oil prices have moderated in the last few weeks, the uncertainty surrounding this market makes it advisable to maximise efficiency in oil use. In this respect, progress has to be made in introducing competition in the energy market and, at the same time, taxation must be revised to stimulate energy saving, since this input represents a significant burden on Spain's trade balance.

Spanish firms are tackling this phase through three lines of action, which the authorities should support.

First, firms are reviewing their growth strategy in Spain. They are analysing the markets in which they compete, but also others in which they still do not and to which demand may shift in the future. Firms will try to see beyond the next few years of low growth to identify opportunities and imagine what the forthcoming needs and demands of consumers will be, in order to position themselves advantageously in those business areas. There are still highly profitable sectors and businesses with plenty of scope for expansion, so firms have to be able to refocus their activity flexibly and to set up new companies without hindrances in a framework of competition. Moreover, the cyclical weakness will require firms to follow a moderate pricing policy and reduce mark-ups, which would be easier to achieve if competitive pressure were to increase in the sectors where it is weakest.

Second, faced with the inevitable fall in domestic demand, firms have no alternative but to turn to foreign markets. It is important to realise that, compared with the foreseeably low growth of national demand in the next few quarters, Spain's export markets may grow at relatively high rates in the coming years. In 2008 Q2, for example, national demand grew by 1.4% in year-on-year terms, while goods and services exports rose by nearly three times that figure. For this reason, efforts to boost the internationalisation of Spanish firms must be maintained. Compared with the 46 million people comprising the Spanish market, the inhabitants of the euro area countries number 320 million and the European single market consists of nearly 500 million. Note that Spain's share of goods exports in world trade is still below its share of world production. Also, Spain sends a smaller fraction of its exports to the emerging economies (whose imports are more dynamic) than the other EU countries. To increase our exports, domestic costs have to remain on a moderate path and the strategies for opening up the economy and fostering trade have to be developed. There are government initiatives to promote economic and trade relations with new areas (such as the Integral Market Development Plans), which are delivering good results and in which firms should not hesitate to take part.

Finally, firms should continue to pursue innovation and quality as a means of enhancing competitiveness, a strategy which calls for specialised, well-trained workers. In this respect, education should pay greater heed to the practical needs of the productive sector by involving the business world more closely in the design and definition of vocational-training and university course contents. Here it is fitting to point out that some areas of education in

Spain continue to produce disheartening results: in particular, the percentage of young people completing secondary school studies continues to be among the lowest in Europe. Hence government policies aimed at remedying this underperformance (in which the regions play a central role) should be prioritised.

Firms, along with trade unions, also face the challenge of containing the effect of the adjustment on employment. Given the repercussions that unemployment has for spending and, above all, for household confidence and the general climate of uncertainty, this variable is crucial, since a smaller impact on employment would reduce the fall in demand and lower the probability of being caught in a vicious circle.

In this connection, it should be kept in mind that all macroeconomic adjustments are different. That seen in Spain in 1992 and 1993 stemmed from an accumulation of substantial losses in competitiveness, which could be recovered fairly rapidly through the devaluation of the peseta. But the devaluation also led to a steep rise in the import bill which reduced Spain's real income and made it necessary to impose tighter financial conditions in the form of high interest rates, making the adjustment of national demand particularly pronounced. In the current circumstances, membership of the euro area prevents a sharp currency depreciation from reducing household purchasing power and, at the same time, limits the possible financial shocks that domestic borrowers might suffer. However, belonging to the euro area also makes it impossible to rapidly restore nominal competitiveness to a more advantageous level for national production. For this reason, it is much more important than in the past for Spain to set in train immediately all the mechanisms that allow it to curtail cost rises and to increase productivity gains, so as to make production competitive and to reduce the negative effects on employment. Hence the external sector could provide a substantial offsetting influence in the adjustment phase and a larger boost to the subsequent recovery.

This moderate cost behaviour demands a responsible response from firms and trade unions to the current labour market situation. Clearly the wage bill cannot be expanded by major pay rises, since this eventually leads to a higher relative cost of labour and, consequently, less job creation, higher unemployment, loss of household confidence and fresh falls in demand, which would mean still lower growth and more unemployment. Therefore, it is crucial to adapt wages to the specific situation of firms, to their activity, productivity gains, profits, etc. The current wage bargaining system does not take into account the large differences in individual firms' specific situations, so it is not the most suitable one to prevent the bout of weak demand from generating a sharp fall in employment.

Further, the predominance of indexation clauses in collective labour agreements is a problem that becomes particularly harmful when, as in the current circumstances, inflation has risen due to an external shock, like oil prices, at a time of cyclical weakness. It is naive to believe that automatic wage adjustment to reflect past consumer price increases provides any protection to household disposable income. On the contrary, these clauses (which have now been done away with in most European countries) lessen the ability of firms to compete and keep creating jobs, generate inflation (which affects those not protected by similar provisions) and, in short, hinder adaptation to the external shock.

In general, these characteristics of the Spanish labour market have meant that employment has so far been the economy's main adjustment variable in periods of crisis, since it is the quantities (i.e. the number of workers) that change given the impossibility of adjusting prices, i.e. wages. Thus it is not surprising that in the past year the unemployment rate in Spain has risen by 2.4 percentage points to 10.4% in 2008 Q2, while in the same period the euro area unemployment rate has remained relatively steady at a little above 7%. The fact that Spain has the highest unemployment rate of the OECD countries should lead us to reform our labour market institutions and improve this lamentable ranking.

Many of my talks in recent months have referred to the activity of Spanish financial institutions. These played an essential role in the fourteen years of expansion and, thanks to their capable management, were in a sound position at the beginning of the international

financial crisis. But it cannot be denied that Spanish institutions face difficult challenges: first, as noted above, although they were not agents of the crisis, they are being affected by the standstill on the international financial markets; second, balance-sheet building by firms and households, which I mentioned earlier, will lead to a substantial moderation of borrowing by these sectors and hence to a reduction in the business of credit institutions; finally, the phase of real-estate adjustment and, in general, of economic slowdown, is already being reflected in increased doubtful assets, although this was to be expected and is still far from reaching alarming levels. For all these reasons, it is clear that there is no room for complacency and that institutions must act to achieve tighter cost control and to rationalise their procedures. Against a background of rising doubtful assets it seems essential to build up both the amount and quality of capital and to establish sound risk control mechanisms. Lastly, institutions should continuously carry out stress testing and develop contingency plans to anticipate what line of action to take in the face of different market situations. Regarding the supervisor, I believe there has been widespread recognition of the reliability and quality of Spanish banking supervision. Therefore this work should continue to cultivate a close relationship and permanent contact with institutions, but without relaxing the demands made of them.

The last agent to which I wish to devote attention is households. In the current circumstances it is inevitable that households should regard the future with greater uncertainty and restrict their spending, stepping up their saving and reducing their level of indebtedness.

The behaviour of households will be influenced by whether or not they are indebted and, if so, the weight of this debt burden on their current income.

In the case of the more heavily indebted households (in proportion to income), the picture is more complicated since, to the prevailing uncertainty about the economic outlook may be added the tightening of financing conditions, which is largely a result of the financial turmoil. It is difficult to predict whether this tightening will continue, although money market rates (the main benchmark in Spanish mortgage loans) now contain a substantial risk premium over the ECB's official rates, currently at 4.25%. In addition, the adjustment phase will lead to a decrease in the high debt of households, which is a necessary step for them to be able to drive a fresh phase of high growth.

As in the case of firms, households will also have to be asked to adapt to the changes. Above all, this calls for a greater effort in training, acquiring professional skills and versatility. It would also be useful if energy saving could be included in households' day-to-day activities, although, as in other areas, the provision of proper incentives by the authorities (particularly through energy price and taxation policies) is crucial.

I would like to end with a message of confidence on the Spanish economy's capacity for growth: the country's productive foundations are much more solid than in the past and there has been a process of convergence with average European income levels which is unlikely to be reversed. Spain is a stronger economy than at the start of the 1990s and its productive and market structures are more flexible and modern. Moreover, macroeconomic stability is assured: the inflation rate will probably be closer to the European average in 2009 and 2010 and the markets expect interest rates to continue at relatively moderate levels, far from the double-digit levels of the 1980s and 1990s. Also, there is a broad consensus about maintaining a high degree of budgetary stability, probably the most significant development in the Spanish economy in the past decade.

That said, the unemployment rate is rising rapidly and the growth rate of activity has begun to decline notably. Today I have tried to put forward the idea that all economic agents (authorities, social partners and households) can contribute to making this adjustment phase brief and to helping the Spanish economy to harness this opportunity to strengthen its foundations for growth. In particular, a bolder attitude on the part of the authorities in their reforms and on the part of the social partners in their shaping of wage-setting and other labour-market mechanisms would lead to an earlier and stronger emergence from this complicated phase.