Jaime Caruana: Overview of the Spanish economy in 2005

Address by Mr Jaime Caruana, Governor of the Bank of Spain and Chairman of the Basel Committee on Banking Supervision, to the Governing Council of the Bank of Spain on the occasion of the presentation of the Annual Report 2005, Madrid, 15 June 2006.

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Ladies and gentlemen,

The vigour of the world economy in 2005 confirmed that the current expansionary phase is proving one of the most dynamic of recent decades. In the past few years, average growth rates not seen since the late seventies have been attained. There are two particularly notable facets to this expansion. First, unlike in previous booms, the world economy has benefited from the salient contribution of the emerging economies. And further, this high growth rate has been accompanied by very moderate inflation rates, a most significant development in the light of their concurrence with a marked and persistent rise in oil prices.

The vagaries of oil prices have, indeed, been central to international economic developments in recent years. The momentum of worldwide demand for energy, combined with its slowly expanding supply which is, moreover, fairly volatile owing to geopolitical tensions and climate-related shocks, pushed oil prices up throughout 2005 and the opening months of 2006 to an all-time high in early May. In turn, other commodities, including most notably industrial metals, have risen substantially. Although the world economy has so far been able to absorb the impact of higher oil and commodity prices, they are a primary factor of risk, and economic policies should remain duly vigilant.

Along with dearer energy, increasing global external imbalances (which, far from being corrected, continued to widen in 2005) are another characteristic feature of the international economic situation. The US external deficit reached a new high, the counterpart of which was the bigger surplus of the emerging Asian economies and, most notably, of the oil exporting countries. This build-up of imbalances reflects the insufficiency of the economic policies geared to their correction in the main economies involved, a point to which I shall return later.

How can we explain the resilience of the world economy in the face of the adverse impact of dearer oil? We must acknowledge that our understanding of some of the features of this upturn is as yet limited, owing among other reasons to the far-reaching structural changes taking place in the world economy, which hamper the diagnosis and interpretation of certain features of the recent expansion. As the main determinants of this resilience, however, we can identify the confluence of expansionary macroeconomic policies, generous financial conditions and strong rises in real-estate and financial assets, against a background of price stability. I shall now address these factors to examine their distinctive features.

As stated, macroeconomic policies remained expansionary in 2005. This needs qualifying, however. Whereas the expansionary stance of fiscal policies scarcely altered in the main developed countries, where public debt continued on a rising trend, the accommodative stance of monetary policies (though, overall, they also helped sustain growth in 2005) was gradually toned down. The main central banks – especially in the United States and, to a lesser extent, in the euro area – progressively raised interest rates and withdrew the unusual monetary stimulus of the previous years. This pattern will possibly also extend to Japan this year, making it likely that, for the first time in 15 years, there will be a phase of monetary policy tightening in the three major developed areas.

In this respect, I should stress that the gradualness of the decisions adopted and central banks' clarity in transmitting them have steered financial market expectations, which has been conducive to their stability and has cushioned the impact of these measures on world growth.

But beyond the generally still-expansionary stance of macroeconomic policies, I believe a significant factor that helps explain the buoyancy of the world economy in recent years is the broadly generous financial conditions that most countries have faced. Real and nominal interest rates at various terms, financial and real-estate asset prices and risk premia have, in general, held at very favourable levels for consumption and investment. In turn, the favourable expectations of economic growth, in a setting of abundant liquidity, fed into rising stock market trends and the reduction in risk premia on corporate and emerging-market debt. The increases in official interest rates scarcely fed through in 2005 to long-term interest rates, which led to the forceful flattening of the yield curve, an unusual occurrence at this stage of the cycle, although the rise in long-term yields in the opening months of 2006 is contributing to lessening the scale of this discrepancy. Finally, the increase in household wealth, stemming from the rise in the value of financial and real-estate assets, eased the drag on real income arising from dearer energy products in the oil-importing countries.

Yet there has been a significant contrast between this optimism on financial markets and the wariness of companies, mirrored by slack investment in the real sector which is particularly striking if regard is had to the favourable trend of corporate profits. Several explanations have been offered for the muted performance of business investment in recent years, such as the difficulties in valuing investment in intangible assets appropriately, over-investment in the second half of the nineties (which caused surplus capacity in recent years), the ongoing reduction in corporations' financial leverage, the uncertainty generated by globalisation and companies' caution following the recent changes in the legislative and accounting framework in the wake of the corporate scandals in some countries. Insofar as some of these factors are probably transitory, greater investment momentum may be expected in the coming years.

The buoyant global demand for commodities and the attendant rise in their prices were conducive to the economic growth of the commodities-exporting countries, while widening the room for manoeuvre of their economic policies. The Latin American countries benefited from this positive effect on their terms of trade, enabling them to reconcile relatively high growth rates with current-account surpluses. In this respect, a clearly contrasting use was made of this greater flexibility by the Latin American countries: while some have sought to strengthen their macroeconomic fundamentals and reduce their vulnerability by limiting and improving the terms of their debt, others have given an interventionist bias to their policies which seriously undermines the maintenance of legal security and dents their medium-term investment and growth prospects.

As stated, an essential ingredient in the stability of the world economy has been the maintenance of moderate inflation, despite the rise in energy and other commodities prices. Admittedly, the dynamism of China and other emerging Asian economies has contributed to this increase in commodities prices; but their penetration in the international markets for manufactures has also helped contain wage and price pressures. The greater anti-inflationary credibility of monetary policies is, in any event, responsible for anchoring inflation expectations at moderate levels, having prevented the so-called "second-round effects" – via prices and wages – that prompted a global inflationary spiral in the eighties in the wake of dearer energy. This diagnosis, far from making us complacent, should be a reminder that such credibility cannot be taken for granted; rather, it has been attained thanks to policies clearly geared to safeguarding price stability, policies which we are bound as central banks to persevere with.

What does the immediate future hold for us? The prospects for the current year point to continuing strong economic growth rates, with a more balanced geographical distribution (owing to the firming of the expansion in the euro area and Japan) and with inflation contained. As I indicated earlier, there are two main risks to this central forecast.

The first is related to the possibility of a further hike in oil and industrial commodities prices. Unlike in the past two years, in which price increases have been prompted by the buoyancy of the demand for energy, dearer oil might be linked on this occasion to supply constraints, which would exert a sharper effect on activity and prices and might bear adversely on agents' confidence. To ward off this possibility, steps must be taken to reduce the world economy's dependence on oil in the medium term, without prejudice to promoting an expansion in production and refining capacity. Moreover, progressive constraints on production globally may generate a greater response by wages and prices to an increase in energy prices. In the face of these risks, and with monetary policies in the main areas closer to a neutral stance (which also entails greater uncertainty about their future course), central banks must persevere with those decisions that bolster the credibility of these policies, since price stability is the best contribution we can make to economic growth.

A second main factor of risk is that continuing world growth might be jeopardised by the presence of growing global imbalances. These could trigger or amplify significant adjustments on international financial markets, such as sharp increases in interest rates and in risk premia.

Correcting the imbalances requires the adoption of appropriate economic policies in each of the main economic zones, policies which will, fortunately, also shore up the foundations for growth in each of these areas in the long run. A clear instance of this complementarity can be found in US fiscal policy, whose moderation would contribute to reducing its external imbalance and would improve its medium-term growth prospects. As to the emerging Asian economies, further steps towards making their exchange-rate regimes more flexible will be needed, especially in China. This will not only contribute to more harmonious and sustainable world growth, but will be an essential ingredient for entrenching progress in China towards higher levels of well-being. Finally, Japan and the euro area should continue on the path of structural reforms geared to increasing their flexibility and adaptability and, ultimately, their potential growth rates, giving particular priority to reforms bearing on the services sector.

Turning to the international financial system, banks have gained in soundness and are now in a position to face a correction of the global imbalances, even if this were accompanied by some adjustment of financial conditions and a moderate increase in volatility. However, further headway must be made in improving the measurement of the risks implicit in the complex financial linkages present in some segments of the international financial system.

Although they provide for greater risk diversification, greater financial integration, new participants on the markets and the emergence of new financial instruments all make it more difficult to determine on which agents and sectors the risks finally fall. It is also more complicated to evaluate, where necessary, the risks of excessive concentration in segments where supervision by regulatory bodies is lighter. It is thus important to foster awareness in companies, and in households too, of the risks they assume, and for regulators to exercise effective surveillance of financial intermediaries and markets. All the more so given that the uncertainty over the effects arising from future bouts of turbulence on the markets will be exacerbated by the fact that this relatively new financial structure has not so far been tested in less favourable phases of the business cycle. In this respect, the volatility seen on international financial markets in recent weeks serves as a reminder of the need for prudent risk assessment and for the right resources to adapt to a broader and more demanding financial environment.

But it is not only the conduct of national authorities that must rise to the challenges entailed by the ever-increasing complexity of our financial systems. At the international level, growing economic and financial integration requires reconsideration of the guiding principles of the multilateral financial institutions, which have hitherto remained perhaps too anchored in the bilateral supervision of national policies, without paying sufficient heed to the increasingly complex links globally. The strengthening of multilateral surveillance, especially in the financial realm, would thereby provide for a more effective contribution by these agencies to embedding international monetary and financial stability.

The European environment

in 2005 the euro area economy posted a modest average increase in GDP, and one lower than in 2004 and than in the other developed economic areas. Nonetheless, year-on-year growth was on a rising profile throughout 2005, attaining a rate of increase in line with potential in 2006 Q1. The economic performance differed, in fact, from the first to the second half of 2005. In the first six months output was markedly sluggish, the result among other factors of the temporary easing in the momentum of world trade, the strong increase in oil prices and the effects stemming from the appreciation, in the previous years, of the effective exchange rate of the euro. After the summer, and although high oil prices persisted, the euro area economy gathered greater steam, driven externally by more robust world demand and some correction in the euro exchange rate, and internally by the progressive thrust of investment. However, and although stock market gains and house price increases generated a positive wealth effect, consumption remained lacklustre, weighed down by the local growth rate of disposable income, against a background of scant job creation and continuing wage restraint.

The inflation rate was influenced throughout the year by the swings in oil prices. Nonetheless, underlying inflation tended to slow, reflecting the scant buoyancy of aggregate demand and of the labour market, and the downward effects on final costs and prices of globalisation and the vigorous emergence on the world trade scene of the developing countries. Early this year, further oil price rises were manifest in a fresh increase in inflation in the area, and also made themselves felt in the underlying component, which may denote a growing rootedness of upward pressures.

In 2005, demand policies in the euro area retained, overall, an expansionary stance geared to reviving private spending in the economy. But in the second half of the year, monetary policy, in keeping with its aim to preserve price stability, adopted an increasingly watchful attitude in the light of the increase in inflationary risks. That led in December 2005, and in March and June 2006, to respective quarter-point rises in official interest rates from the historically low level of 2% at which they had held since

June 2003. Despite these rises in official rates, the Eurosystem's monetary policy stance has remained propitious to the firming of the pick-up in activity and job creation. Nonetheless, the ECB is closely monitoring developments in the euro area to ensure inflation expectations remain in line with price stability over the medium term.

Budgetary policies adopted a moderately contractionary stance in the area as a whole, although the persistent fiscal imbalances in several Member States continued. Consequently, the current firming of higher growth rates should drive more resolute action to correct these imbalances, the persistence of which may, in some Member States, have dented agents' confidence and may thus affect their spending decisions. The reform of the Stability Pact appears to have successfully concluded a phase of uncertainty over the application of regulations relating to the fiscal policy discipline of the euro area countries. However, preserving the credibility of the new framework requires an unequivocal and ongoing commitment by the national authorities to strict compliance with the Pact.

The recent persistence of sluggish growth rates, despite highly favourable financial conditions, highlights the pressing need to see through the European structural reform agenda with firmer resolve. The revision of the Lisbon strategy in 2005 may contribute to driving this process. Nonetheless, as in the case of budgetary policies, a common framework for action is only effective if accompanied by the sufficient political resolve to adopt the measures that enable programmed objectives to be met. In the case of structural policies, these are chiefly oriented to stepping up the use of the labour factor and to increasing the pace of productivity through the promotion of knowledge, innovation and the incorporation of new technologies.

As earlier mentioned, the phase of more dynamic economic growth initiated around mid-2005 continued in the opening months of 2006. The main international organisations have forecast a rate of increase in GDP in the euro area of slightly over 2% in 2006, i.e. around potential. This recovery will foreseeably be underpinned by the strength of domestic demand, among whose components investment is expected to post a high rate, while private consumption will probably trend more moderately, albeit at a somewhat higher rate than in recent years, in step with the gradual improvement expected in the labour market.

However, there are some factors of risk clouding this outlook. In the external environment, such factors comprise the existing global imbalances and the persistence of high oil prices. On the domestic front, employment and consumption are the factors subject to most uncertainty.

The inflationary outlook for 2006 and 2007 indicates that the rate of change of the HICP may be close to the price stability benchmark of 2%, or might even exceed it again. Yet upside risks persist here, stemming mainly from the possibility of further increases in oil prices – given the instability of the market – and from the potential emergence of second-round affects in a more buoyant economic setting. But the fact that the level of output is still below potential provides leeway for the recovery to continue for some time without generating excessive inflationary pressures. In any event, the European Central bank will remain watchful so as to prevent risks to price stability in the medium term from materialising.

The Spanish economy

Throughout last year and in early 2006, the expansionary cycle of the Spanish economy continued and intensified, in contrast to the difficulties experienced in the euro area as a whole in emerging from the phase of low growth currently in train. Spanish GDP increased by 3.4% in 2005, while employment advanced at an equally high rate of 3.1%. In both cases, these rates were several tenths of a point up on the previous year's figures. Moreover, 2005 saw the publication of the new Spanish National Accounts base 2000 figures, which meant a considerable upward revision of economic growth since 1995 and, especially, since 2000. These new estimates reflect more appropriately the dynamism of the population and of employment these past few years, and they show a more buoyant economy more closely in step with the expansionary behaviour seen in other economic variables such as credit or tax revenue.

As a result of this trajectory, there has been fresh headway in Spain's real convergence with the EU and with the euro area. On the latest provisional estimates available, Spanish per capita GDP stood in 2005 at over 98% of the EU average, more than five percentage point up on its level in 2000. There were also significant improvements in the form of greater labour market participation and a lower unemployment rate, aspects where the traditional differences with the core European countries have narrowed substantially. The decline in the unemployment rate is particularly noteworthy. It now stands at a similar level to that observed in the main European countries, following several decades in which a high unemployment rate was singled out as the most characteristic problem of the Spanish economy, even in cyclical upturns.

The performance of the Spanish economy in 2005 and early 2006 reflects the continuity of the expansionary impulses operating on the growth rate and on job creation. Monetary and financial conditions have remained markedly loose in the light of the economy's domestic situation, having been determined by the prevailing price stability and sluggishness of activity in the euro area as a whole. The low levels of interest rates have continued to combine in Spain with the significant rises in financial and real-estate asset prices (although in the latter case they have tended to ease off), which has reinforced their impulse to spending. In these circumstances the gradual withdrawal of the Eurosystem’s expansionary monetary policy stance, begun in late 2005, has only partly reduced the looseness of financial conditions.

Immigration flows, which remained very high in 2005 according to the information available, were a further factor behind the dynamism of economic activity and employment. They also added some flexibility to production and working arrangements. On one hand, the increase in the immigrant population has sustained the thrust of domestic spending, while on the other, the resulting greater supply of labour has increased the Spanish economy's productive capacity, enabling increases in output more closely tailored to the buoyancy of demand to be attained. Furthermore, the presence of this additional labour – which has a comparatively higher degree of mobility – has contributed to restricting potential sectoral bottlenecks and the wage pressures that usually characterise situations of notably vigorous expenditure, such as that seen in recent years.

The composition of growth in 2005 evidenced few changes in relation to previous years, in step with the continuity of the impulses received by the economy. Indeed, the growth pattern became slightly more unbalanced, as national demand grew by 5.1%, outpacing the related increase in 2004, while foreign trade gave rise once again to a substantial negative contribution to GDP growth. Household consumption and housing-related spending continued to be the main underpinning of the increase in demand, supported in turn by the sound growth of disposable income and of employment, and by the generosity of financial conditions in the economy. As a result, households continued to reduce their saving ratio and to increase their net demand for financing.

The principal new development in 2005 was the marked recovery in corporate productive investment expenditure, which focused particularly on the acquisition of capital goods. This pick-up was accompanied by a strong increase in credit, favoured by accessible financing conditions. Credit was directed especially at small – and in principle more dynamic – companies, and it spread to all sectors of the economy, including manufacturing industry. Public-sector demand also quickened last year, driven by the rise in investment that characterises the initial years of a legislature and by the increase in government consumption.

As stated, the unbalanced features of this growth pattern were manifest again in 2005, especially in the behaviour of the external sector. Flat goods exports, despite the burgeoning growth of foreign markets, combined with a fresh and significant increase in imports to give rise to a further deterioration in the negative contribution of net external demand, which had already been very marked in 2004. A mix of factors was involved here: first, the increase in the energy bill and the greater buoyancy of demand in Spain compared with its EU neighbours, which partly reflects Spain’s different cyclical position; and further, the losses in competitiveness that have built up in recent years (and to whose source and consequences I shall refer later), along with other structural factors relating to the sectoral and trade composition of our economy.

In annual average terms, the discrepancies between the behaviour of domestic spending and of net external demand were further accentuated in 2005; however, throughout the year there were incipient signs of a change in the composition of growth, as national demand embarked on a slight slowdown and as a likewise modest correction was seen in the contractionary contribution of the external sector. Nonetheless, initial estimates for the opening months of 2006 would suggest that this rebalancing of the composition of expenditure has come to a halt, against a background in which activity has continued to grow sharply.

In the absence of sufficiently appreciable changes in the drivers of the expansion and of significant corrections in the pattern of growth, the imbalances already building up in the Spanish economy have become bigger and certain factors of vulnerability to potential future shocks have been accentuated. The high growth rates of domestic demand have combined with the inertia persisting in cost and price determination and have continued fuelling the inflationary pressures that have been eroding the economy's competitiveness. In turn, the fact that private-sector spending has outpaced income-generating capacity has made for fresh increases in corporate and, above all, household debt, and for a growing resort to external saving. Both factors resulted in an ongoing deterioration in the nation's borrowing requirements, despite the fact that the public sector has appreciably increased its saving capacity. The Annual Report I present today analyses closely the different factors bearing on this diagnosis, and I shall now refer briefly to them.

Spanish inflation has continued trending at a high rate, above that of the euro area, with the differential between the two widening. Although the Spanish economy is more dependent on oil imports than other countries in the area, the inflationary performance cannot be attributed to the direct impact of the strong hike in oil prices in 2005 and early 2006. Indeed, the underlying inflation (excluding energy and unprocessed food prices) differential with the euro area has widened more than that of the overall index, a pattern that has been exacerbated in the opening months of this year in which industrial goods prices have accelerated.

Looking at the determinants of the inflation differential on the costs side, it can be seen that, unlike in previous stages, the relative increase in margins has contributed more to the deterioration than the rise in unit labour costs. The widening of margins behind this behaviour has been more marked in the activities less exposed to competition, such as construction and services, which is also where demand pressures have been sharpest.

Wage increases agreed under collective bargaining have not diminished and the impact of the indexation clauses is proving considerable both in 2005 and in 2006. However, average labour costs have grown at relatively moderate rates as a result of the rise in employment in industries with comparatively lower wages, which are those where the influx of immigrants is proving greater. In this respect, the sizeable immigrant inflows are acting as a factor of wage flexibility in certain labour market segments. In any event, while this behaviour of wages may be considered moderate, compared with their historical, upward pattern, growth has remained higher than that of wages in other euro area countries. Moreover, these developments have taken place against a background of very low productivity gains, meaning that the cost growth differential with the euro area has remained wide. This differential is proving particularly harmful for manufacturing industry, which has continued under increasingly sharp pressure from foreign competition.

It should be borne in mind that, in the euro area, the consequences of losses in competitiveness induced by continuing demand pressure may be difficult to reverse. This is because they require a direct adjustment of relative prices and costs based on the effective moderation and the sufficiently flexible behaviour of wages. In Spain's case, moreover, given the specialisation of the productive structure in industries where demand is more sensitive to relative prices and in which the pressure exerted by products from the emerging economies is very high, companies may find themselves having to make a sharper adjustment to make up for lost ground on international markets and on the domestic market. That all shows how important it is for the economy to have flexible price- and wage-setting mechanisms. And there is a general need to reinforce the capacity of the productive system to compete, through improvements in specialisation, efficiency and higher productivity gains.

As earlier indicated, the growing mismatch between household and corporate expenditure and income last year has been accompanied by fresh increases in these sectors' debt. What has proven conducive to this has been the maintenance of financial conditions which have continued to be markedly loose for the situation of strong demand pressure in the economy. This growth in household and corporate liabilities is naturally bearing on the financial position and burden of both sectors.

The financial pressure borne by households has, however, been alleviated by the increase in their net wealth, sustained by the growth of stock market prices and, above all, of house prices. In the case of companies, the notable increase in profits has strengthened the sector's capacity to withstand the increase in their financial commitments. Accordingly, the financial position of both sectors, considered overall, remains sound and does not therefore pose a serious obstacle to the continuity of the economic upturn currently in train.

The foregoing should not, however, conceal the evident fact that the expansion of domestic spending, particularly in the case of households, will not be able to base itself for much longer on growth in debt at rates such as those currently seen. Moreover, the ongoing rise in indebtedness levels and the prevalence of debt incurred at variable interest rates entails a greater sensitivity of the Spanish economy to monetary policy decisions, against a background in which the present generosity of monetary conditions may be expected to move to a more normal footing. The influence of interest rates on expenditure is undoubtedly sharper in the case of relatively more indebted households, which are in the lower strata of the income distribution.

Along these same lines, the strong concentration of household wealth in property and the relative weight of productive activities related to the residential sector are resulting in a greater exposure of the economy as a whole to the changes in property-market activity and prices. Regarding the latter, 2005 appears to have marked the start of a slowdown in house prices, raising (all the more so the more firmly the deceleration becomes entrenched) the likelihood of the current overvaluation of housing being progressively reabsorbed, as in previous booms. Let me remind you, however, that some element of risk is always present in all scenarios involving the absorption of a phase of overvaluation. This is a consideration that all agents should bear in mind when deciding where to place their investments.

Any assessment of the consequences arising from the greater exposure of the Spanish economy to changes in house prices and in interest rates would be incomplete were it not also to allude to the parallel developments reinforcing the economy's capacity to face potentially adverse shocks in any of these variables. In this respect, it should be underscored that the behaviour seen in recent years in the main indicators of the activity, profitability and solvency of domestic credit institutions is helping mitigate the financial risks bearing on the course of our economy in the medium term. These institutions are therefore well positioned to absorb the potential impact of shocks such as those indicated without seeing their capacity to ensure the financing of economic growth affected.

Undoubtedly, the prolongation of the phase of robust demand has contributed to widening the economy's external imbalance, increasing the need to resort to foreign saving to finance private-sector spending. Overall, the external deficit, whether measured by the current account balance or by net borrowing, reached a new all-time high last year.

As is known, belonging to a monetary union substantially changes the meaning and consequences of the current account balance. The breaking of the link between the exchange rate and the economy's external imbalance gives greater prominence to how this imbalance is financed. Here, the funds needed to bridge the gap between national investment and saving are being routed essentially via the issuance of securities by banks and, especially, non-bank financial institutions. These securities, such as mortgage-backed bonds, are linked to credits guaranteed by property assets.

However, the fact that the external deficit is easier to finance within a monetary union should not conceal the factors of uncertainty derived from the losses in competitiveness and the growing indebtedness of households and firms underlying the deficit, because they may ultimately affect the sustainability of medium-term growth.

In the short run, forecasts are for the continuity of the expansion. The central scenario for the coming quarters is set against the substantial buoyancy of the world economy, the smooth adjustment of monetary and financial conditions and the gradual re-absorption of the overvaluation of housing. And it continues to point to a gradual rebalancing of spending, with a slowdown in domestic demand and an improvement in the contribution of external demand. We are thus before a scenario that offers, in principle, sufficient room to face the vulnerabilities that have emerged and to address the measures needed to consolidate the continuity of the expansion. But there is a risk that the restructuring of spending will not be of sufficient intensity or that it will not increase the responsiveness of supply to the extent needed, meaning that the imbalances will continue to grow deeper, thereby raising the probability of a more marked adjustment in the medium run.

Economic policy challenges

Given the situation described, an economic policy commitment to rebalancing demand and, in particular, to containing domestic expenditure is particularly necessary. The aim is to ensure the Spanish economy continues moving towards the income levels of the core European countries and that it is in a position to become successfully integrated into an increasingly competitive and globalised international environment. To do this, the potential for economic growth must be broadened, reinforcing the significant contribution made by the increase in employment in recent years with the attainment of real productivity gains.

Under demand policies, monetary policy may be expected gradually to resume a more neutral stance and somewhat higher interest rates. The mild tightening of monetary conditions will contribute to some extent to containing consumer and residential-investment spending. But it is unlikely, in a setting in which cyclical divergences of some intensity persist between the countries comprising the euro area, that this will suffice to promote the necessary adjustment from the domestic standpoint. The contribution of fiscal policy is therefore crucial, and the room for manoeuvre available should be used to reduce the pressure of domestic demand, through the pursuit of more ambitious budgetary targets.

In this respect, the sound fiscal figures obtained in 2005 – a surplus of 1.1% of GDP and a fresh cut in the public debt ratio, which has dipped to close to 40% of GDP – should be built on and improved in 2006. Indeed, the figures for the opening months of this year suggest the marked buoyancy of tax revenue will continue, raising the likelihood that public revenue will once again outpace budgetary projections. In this case, and from the perspective of the macroeconomic scenario of sustained growth projected for 2006, the general government surplus should feasibly and desirably stand a few tenths of a point above the 2005 figure, improving on the target of 0.9% set in the last Stability Programme update. Such a result would further the strategy pursued in recent years aimed at strengthening the stabilising nature of fiscal policy, which will be bolstered by the entry into force next year of the new budgetary stability legislation.

The healthy position of Spanish public finances is evident from comparison with those of the other European countries, subject to the common fiscal discipline rules established by the Stability and Growth Pact. But this situation should not sideline significant challenges ahead. Most immediately, public-sector participation in various structural reform programmes, such as the National Reforms Plan, and compliance with the commitments made to improve the quality of certain services, such as healthcare, and the provision of new welfare benefits (some far-reaching, such as the coverage of situations of dependency) will require further efforts to achieve more efficient management of spending and of public revenue.

From the standpoint of public revenue, the direct tax reform due to be enacted in 2007 contains features conducive to greater efficiency in the allocation of resources. As regards income tax, the reform is a significant step towards tax neutrality for saving. In respect of corporate income tax it is intended, in addition to reducing the rate in line with international trends, to make more rational use of the system of tax allowances and deductions. Although it is estimated that the impact of tax reform on revenue will be small, its effect on activity will be slightly expansionary. Accordingly, if the economy retains its current dynamism, it might be necessary to introduce some compensatory adjustment. It should be recalled that the entry into force of the EU Financial Perspectives 2007-2013 will entail fewer financial flows from Community coffers. That all reinforces the need in the coming years to design budgets that add to the stabilising role of fiscal policy.

On the public spending side, now most spending powers have been decentralised, the co-ordination mechanisms between the different tiers of government must be strengthened. I should moreover stress the importance, once very high levels of decentralisation are in place, of achieving a greater degree of commitment by all levels of government to budgetary stability. The failure by many regional governments to meet the budgetary stability target in 2005 and the deficit projections for 2006 are warning signs for potential shortfalls, which should be prevented and avoided. The new stability laws should contribute to identifying and correcting these potential situations, promoting prompt and transparent information on regional public finances.

Lastly, some comments on the challenges posed to the sustainability of public finances over the medium and long term, derived from population ageing. I would say that the delay in adopting reforms for public social protection systems reinforces the need to achieve healthier positions in the short term, providing for further cuts in the public debt ratio or, alternatively, for making appropriations to the pension reserve fund with greater speed and intensity. Moreover, this need increases in the absence of more ambitious reforms in the labour market to further promote the use of still-idle labour resources, despite the progress in increasing participation and reducing unemployment.

I talked earlier of the advisability of having more efficient cost- and price-setting mechanisms to smooth the adjustments the economy has to make in the context of EMU. In this respect, the fact that issues relating to the structure of collective bargaining have been relegated on the agenda of potential labour market reforms is a cause for concern. The wage bargaining arrangements included in the Inter-Confederal Agreements for Collective Bargaining, habitually signed by social agents, restrict the capacity to adjust wage increases to industry- or firm-wide productivity developments, in addition to setting a floor for the increase in nominal wages. The indexation clauses included in a high proportion of agreements have particularly harmful effects when exogenous price-rise shocks occur, as with the current hike in oil prices, since they tend to reinforce the upward inertia of wages. Collective bargaining arrangements should be made more flexible to provide a framework in which, establishing the necessary guarantees for workers, wage and working conditions are adapted more readily to the needs of an efficient and competitive functioning of firms and industries.

It is also crucial to promote permanent hiring, to correct the duality persisting in the labour market, since the ratio of temporary to total employees has continued to increase in 2005 and in 2006 to date. The agreement on labour market reform recently signed by the social agents and the government is a very timid step in this direction; although it seeks to discourage temporary hiring (with results that are difficult to assess in advance), it leaves some of the core problems underlying the restrictive use of permanent hiring largely unchanged. In particular, although a more transparent system of rebates has been introduced for this type of hiring, the dismissal costs linked thereto have not been changed. In this connection, mention may be made of the extension to 2007 of the period in which employers can convert temporary contracts into permanent ones, availing themselves of the employment-promoting contract, which envisages a smaller redundancy payment.

The issues pending in the field of labour reform are very important, since this is a very significant area for the effectiveness of the numerous liberalisation measures implemented first, under the *Plan de Dinamización* (plan to bring about a more dynamic economy), and further under the National Reforms Programme. The proper implementation of these programmes, which have been favourably assessed in the European Commission's follow-up of the Lisbon agenda, is vital if the Spanish economy is to leave behind the path of low productivity growth on which it has been moving. Undoubtedly, the high availability of labour is a factor that partly explains the low increases in productivity. But this should not mask the difficulties faced in increasing and modernising productive capital, in properly training labour and in incorporating technological advances, difficulties that must be overcome to improve the competitiveness of the productive system.

Market flexibility and efficiency is a vital requirement for sustaining long-term growth in an area of monetary stability. And it is all the more vital if, as in the case of the Spanish economy, the starting point involves a lag in technology and a relatively low level of productivity. This is why it is so important to move forward the Lisbon strategy in our country. The challenge lies, therefore, in translating the programmes designed into effective government action that is capable of mobilising the innovative energy of the private sector and of extending action to other key areas still requiring a liberalising boost, such as the retail trade sector and the land, housing and rentals markets.

The financial system

During 2005 Spanish deposit institutions operated in a benign domestic and international environment, both from the macroeconomic and financial-market perspective. Against this background, 2005 was marked by the continuing strong growth of financing to the resident private sector, especially the financing of activities linked to the property market. Nonetheless, the change in the monetary policy stance and the increased volatility of financial markets in recent weeks have renewed doubts about the continuity of this setting.

The growth of mortgage credit has been accompanied by the emergence of new bank products. It has thus been possible recently to observe a lengthening of the terms at which mortgages are granted, to limits considerably in excess of those banks are accustomed to handling, and greater flexibility in the deferral of principal and interest payments, as well as the possibility of being able to draw automatically on amounts repaid in order to finance other needs.

These financial innovations, which are characteristic of mature financial markets, enable financial institutions to satisfy customer requirements with greater flexibility, and the possibilities of financing individuals and firms may be increased. However, substantial extra efforts are required by bank managers to properly measure and control the additional factors of risk and also to provide customers with the necessary information so that they may assess their ability to pay under various alternative scenarios.

The increase in financing granted to property market-related activities is not confined to that extended to households for house purchases; financing extended to construction and property development companies has also grown notably. The degree of concentration of entities' credit portfolios in construction and property development activities increased once again in 2005. That also requires managers' attention, in a setting in which there is a greater likelihood that the accommodative stance of monetary conditions will progressively be normalised and that the slowdown in house prices that appears to have begun will continue and even intensify.

The forceful increase in banking activity, and particularly in credit to the resident private sector, has not been accompanied to the same degree of intensity by the raising of funds through traditional liabilities-side instruments such as deposits. In this respect, there was a stronger tendency in 2005 to seek additional financing on the financial markets through the issue of mortgage covered bonds and other securities, or through asset securitisation. Although this usually entails more costly financing than the raising of more traditional resources, it is no less true that Spain's incorporation into a stable zone, such as the euro area, has provided our institutions with access to efficient capital and interbank markets.

Access to international markets, mainly in the euro area, has assigned to credit institutions a central role in the channelling of saving from the rest of the world to our economy, and, in the case of securitisation, it has helped transfer part of the risk to foreign investors. This may mean that the external financing conditions for credit institutions and for the Spanish economy may be more sensitive to the circumstances of capital markets and to developments on property markets in our country. Institutions should thus make allowances for less favourable future scenarios of access to these international markets than those seen in recent years.

The expansion of activity during 2005 was not restricted, however, to credit extended; banks also offered a wider range of non-typical banking products, such as insurance, and mutual and pension funds. Likewise, activities pursued abroad contributed to making bank balance sheets more dynamic. In this respect, the geographical composition of Spanish deposit institutions' financial assets abroad changed considerably last year. While Latin America continues to hold a relevant position, the European Union has become notably more prominent, and now accounts for the highest proportion of assets.

In 2005 Spanish deposit institutions' results, the first line of defence against potential difficulties, posted sizeable growth rates, confirming the sound position seen in previous years. It should not be forgotten, however, that a greater degree of dispersion and volatility is to be expected further to the application of the new accounting principles introduced by Banco de España Circular 4/2004.

In any event, the considerable increase in business volume, the greater leverage of credit institutions and the drive to contain operating cost increases have allowed high profitability ratios to be maintained, despite the moderation of the financial margins. The clearest expression of this was the return on equity; once again in 2005, its spread over long-term public debt continued to widen.

Spanish deposit institutions have been operating reasonably comfortably above the minimum capital ratio, although the sharp growth of activity has reduced the solvency ratio to below what has historically been the case in our banking system. This comfort margin provides some room for manoeuvre in the face of potential shocks, especially when regard is had to the quality of such capital and its regular generation.

Growth in activity such as that hitherto described, against such a favourable macroeconomic and financial-market background, should not lead bank managers to feel complacent. On the contrary, the difficulties of sustaining the growth rate of activity, the foreseeable normalisation of favourable monetary and financial conditions and the recent increase in volatility on international financial markets against a backdrop of historically low risk premia requires watchfulness and reflectiveness concerning the business strategy in different environments. The analysis of adverse scenarios is a vital tool in situations of rapid and far-reaching change, so that responsiveness to combinations of adverse shocks may be determined; though such shocks are not the foreseeable central scenario, they should be part of any financial institution's risk analysis.

From the regulatory standpoint, 2005 was also an intense year. Throughout 2005 credit institutions successfully applied the new accounting Circular, working on their adaptation to the New Capital Accord. These implementation efforts were not confined to 2005, but must continue over the coming years, with a follow-up on the most novel aspects of the new accounting rules, especially in respect of capital, transparency and management accountability.

The growing importance of transparency and corporate responsibility is not restricted to the accounting realm. Indeed, corporate governance is a key aspect in all financial systems. This is acknowledged by the Basel Committee on Banking Supervision, which has approved a specific guide for deposit institutions. The guide seeks to complement other codes, placing particular emphasis on organisational, risk-control and transparency aspects.

Growing cross-industry and cross-country integration also has consequences for supervisors, who can increasingly less exercise their powers in isolation. Accordingly, national supervisory activity should best form part of the set of initiatives and activities at the international level, especially the activities of the Basel Committee on Banking Supervision and the Committee of European Banking Supervisors, which were both chaired in 2005 by the Banco de España.

Once the chapter dedicated to the capital framework and the trading book was concluded in July 2005, both Committees directed their efforts at supervisory co-operation and at enhancing consistency of implementation, thus supporting the idea that a regulatory pause might improve the quality of implementation of this regulation. The call for regulatory convergence to be accompanied by a convergence of supervisory practices is particularly intense in the EU. Fora such as the Basel Committee's AIG (Accord Implementation Group) or the CEBS (Committee of European Banking Supervisors) in the EU are a response to this call. But growing co-operation with counterparts in other countries is also vital for supervisors, because a global financial system cannot be effectively supervised without a suitable degree of co-operation providing for mutual trust and information exchange. International co-operation, in sum, is a cornerstone of global financial stability and of the extension of best international practices in this field.

Within Europe, the new capital directive reinforces this approach by establishing colleges of supervisors for transnational financial groups, but also through the role of lead supervisor on a consolidated basis. Moreover, the extension of the so-called Lamfalussy approach from the securities industry to banking and insurance is a clear commitment to a co-operative and evolutionary approach, constructed on the strength and knowledge of national supervisors. This supervisory co-operation-intensive model increases the responsibility of national supervisors, since it is only sustainable insofar as it provides appropriate responses, eliminates obstacles and encourages the necessary financial integration.

Although only about 40 of the 8,000 European deposit institutions engage in significant transnational activity, the European banking market is integrating at considerable speed. Even though the pace of integration may seem limited, with few cross-border operations annually, international competition in each of our domestic financial systems is increasingly patent and intense. Further, some market segments have undergone unprecedented growth. The euro interbank market and the asset-backed bond market are now fully integrated and fully accessible to more than these pan-European institutions. Such is the European financial system, which combines integrated segments with retail banking markets that are not even national but local, and transnational institutions among the biggest in the world with small banks with just a handful of employees. Accordingly, the lifting of barriers to integration must remain high on the agenda of Community and national authorities.

I would not wish to conclude this section without referring to the efforts of the Banco de España to inform bank customers. But before discussing our initiatives in this area, we should stress that our efforts here are aimed at reinforcing financial stability. Just as solvent, efficient and competitive entities are the best guarantee of stability in a financial system open to international competition, customers with sufficient financial acumen who are demanding in their dealings with banks are also a basic pillar of the efficiency of the financial system and of its stability.

In 2005 the Banco de España instituted its bank customer's portal. This provides consumers with overall information on the risk characteristics of different products, on their rights and on the commissions applied by institutions to their customers. A provisional evaluation of the results is very favourable, but at the same time leaves no room for complacency. This is an area where we must make greater efforts, improving co-ordination with other supervisory and consumer protection agencies. Issues as basic as the advisability of diversifying saving between entities and products, or the absence of high returns unless greater risk is involved, are not yet part of consumers' basic financial culture. And while this remains so, consumers will be exposing themselves to risks without being aware they are incurring them.

National co-ordination mechanisms between the Ministry of Economy and supervisors were also strengthened in 2005. In response to ECOFIN's recommendations, a memorandum of understanding was signed by the Ministry of Economy (not only in its main function, but also in its capacity as supervisor of the insurance industry), the Banco de España and the CNMV (National Securities Market Commission) on co-operation in financial stability. This agreement, which is the natural extension to the national realm of that signed in the EU by the Ministries of Finance, central banks and banking supervisors, without modifying their respective powers, simply gives written expression to what were already fluid relations between the Ministry and supervisors. As a direct consequence of this agreement, a national Financial Stability Committee was set up and has since begun operating.

As usual, the final part of my address shall be devoted to the recognition and appreciation of the Banco de España staff for their effort and dedication, and to the members of the Executive Commission and of the Governing Council for their support and collaboration. Especially so on this occasion, as this speech marks the end of an intense and enriching professional experience for me. It has been a privilege to work, along with the Deputy Governor, the Directors-General and the members of this Council, at the helm of this institution over the past six years. I believe that during this period we have succeeded in preparing this institution for the role it must play as a consequence of the new institutional framework EMU membership entails and the role the Spanish economy is called on to perform on the global stage. This has all been possible thanks to the efforts and dedication of our staff, and also thanks to your professionalism, steadfastness, independent judgment and institutional loyalty, which make the Banco de España a very special place.

Looking back, I would like to extend my gratitude to the former council members. And I have a very special memory of Eugenio Domingo Solans, who rendered so many services to this institution, both in his two spells on the Executive Commission and during his stay at the European Central Bank.

Allow me to conclude briefly by expressing my personal gratitude to the deputy governor, to whom I shall always be indebted. Our co-operation and understanding over these years has been so intense and mutually supportive that in appreciating his work I feel as though I were praising myself. So, Gonzalo, getting straight to the point as we both prefer, let me say in public just two short words: thank you.