

## **Miguel Fernández Ordóñez: The international economic scene and analysis of the Spanish economy**

Speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, before the Senate Budget Committee, Madrid, 23 November 2006.

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Ladies and Gentlemen,

Appearances by the Governor of the Banco de España before Upper and Lower House committees, as part of the discussion and approval of the State Budget, have traditionally been one of the main occasions for Parliament to deliberate on the analysis of the Spanish economy that forms the basis of the central bank's actions.

As this is my first appearance as Governor before the Senate, allow me to reiterate, as I did in the Lower House, the importance that I attach to relations with the people's representative bodies for the proper performance of the tasks entrusted to the Banco de España. Tasks which are of great importance in the light of macroeconomic and financial stability, and which justify the independence granted by European laws and treaties to the Banco de España. Indeed, this is one of the Bank's main identifying features, but one whose corollary is full transparency and fluidly operating accountability. At issue here, therefore, is an institutional arrangement whose balance hinges significantly on relations between the Banco de España and Parliament.

Before moving to the analysis of the Spanish economy, I should dedicate some time to the external environment, focusing on the euro area, which is where our monetary policy is designed and decided.

The international economic scene has been marked throughout 2006 by the continuing robust growth in global trade and activity seen in recent years. Such growth has been particularly notable in that it has come about against a background of considerably high oil prices which have only eased in recent months. It is very likely that in the coming quarters this dynamism will be maintained in most of the main geographical areas. Nonetheless, signs have emerged lately of growth easing in certain areas, most notably in the United States, meaning that the pace of expansion of global activity as a whole should be somewhat more contained in the immediate future.

Thanks to this global framework, the euro area's economic situation has improved substantially. On most available forecasts, GDP in the area could grow by around 2.5% this year, marking a significant acceleration on 2005. Accompanying this greater dynamism has been the recovery in internal demand, which should contribute to extending the length of this upturn. Prominent among the internal expenditure components is the robustness of investment, both in capital goods and in construction. The persistence of highly favourable financial conditions, companies' improved financial position and their higher earnings have contributed to buoyant corporate investment, in a setting in which capacity utilisation has reached the highest levels of the past five years and unit labour costs remain moderate.

Household spending has recently gained some momentum and the course of the determinants of this variable paint a favourable picture. In particular, the employment growth rate has reached levels unknown since the start of the decade, and this has been duly reflected in the indicators of consumer confidence.

Overall, the information available suggests the expansionary phase of euro area output will continue over the coming quarters, though possibly at a somewhat lower rate than in the first half of 2006. In any event, around the turn of the year the economic situation will foreseeably be perturbed by the temporary impact of the rise in the main VAT rate in Germany in early 2007. Against this background, medium-term risks of a growth downswing cannot be ruled out if the slowdown in the US economy becomes more intense. Adding to this uncertainty is the possibility that oil prices will resume the upward course interrupted in August and, over a longer horizon, that there will be a disorderly correction of the macro-financial imbalances between the main world areas.

The most recent changes in the growth rate of the harmonised index of consumer prices have been much assisted by the marked decline in oil prices since mid-August and by the stripping out of the base effects from the previous year. These factors have meant that, for the first time since early 2005, inflation has stood below 2%, the ECB target (it stood in fact at 1.6% in October). Beyond the temporary variations in this variable, the index that excludes energy goods prices has also performed

more favourably throughout the year. The absence to date of underlying inflationary pressures is also seen in the moderate evolution of labour costs and of the indicators of long-term inflationary expectations. However, the upside risks to inflation have been growing in step with the improvement in activity and employment, which might drive the pass-through to consumer prices and wages of past rises in energy product prices. Faced with this, the ECB decided to readjust monetary conditions by raising its official interest rates on five occasions since December 2005. These measures have proved necessary to keep inflationary expectations anchored at lower levels, against a background of strengthening aggregate demand and a gradual move closer towards the potential level of output. In any event, I should stress that at present, even following these interest rate rises, the financial conditions in place remain conducive to economic activity.

Having a monetary policy geared to ensuring price stability is a vital requirement for economic dynamism to be sustainable. However, monetary policy can in no way supplant the other economic policies which, in fact, are of paramount importance for the growth of our economies.

In particular, the European authorities must strive more resolutely to eliminate the structural obstacles holding back growth potential. The relatively disappointing results in terms of economic expansion in the euro area in the past decade are due, above all, to the scant dynamism of labour productivity which, in turn, is largely a response to the relatively modest pace of innovation, and its spread and application to the rest of the economy. Overcoming this problem requires the implementation of a broad array of measures aimed at stimulating human capital formation, providing for the creation of new companies promoting the development of new products and combating rigidities in the different markets.

On the other hand, there has recently been an improvement in the use of the labour factor, suggesting that labour market reforms and wage moderation have yielded some benefits. However, much room remains for further progress, since the unemployment rate is still high and the number of hours worked and the employment rates for specific groups (women, youths and older individuals) are too low.

On the fiscal policy front, budget balances have recently seen what was in part an unexpected improvement. This is because the pick-up in activity has given rise to more vigorous growth in certain tax receipts than was foreseen a year ago. The increase in revenue is therefore essentially transitory, therefore the authorities of these countries would be mistaken to become complacent and believe that budgetary consolidation has become a less pressing task. On the contrary, it is necessary to maintain sufficient control of spending in the economic upturn so as to speed up the correction of budgetary imbalances. This objective is vital for creating a stable macroeconomic environment and increasing the headroom available to tackle the challenges posed by population ageing in the future.

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The changes I have described in the international setting, where the greater dynamism of the euro area and, therefore, of our export markets is notable, along with the gradual withdrawal of the impulse provided by monetary conditions, all shape a favourable scenario in which the Spanish economy may continue growing at a high rate in a sustained fashion. The easing in oil prices has led to a marked slowdown in the inflation rate, which it would be highly desirable to consolidate in the coming quarters.

The information available on the first half of 2006 shows the Spanish economy has remained very strong, with activity even moving on a mildly accelerating path. This means that the improved external environment has so far offset the slight tightening of financial conditions, which has made for some re-balancing of the sources of growth of our economy, in favour of the external sector and with a smaller contribution by national demand. The increase in GDP growth in Q3 is along similar lines, with a year-on-year growth rate of 3.8%, as a result of a further improvement in the contribution of net external demand to output. This will allow activity to expand over the course of 2006 at a sharper rate than in 2005, meaning the current year would show the highest growth rate of the present decade.

Yet despite this narrowing of the gap between the contributions of national and external demand to growth that I have referred to before, the expansion of the Spanish economy in 2006 has essentially been underpinned by the buoyancy of domestic spending. In particular, gross capital formation has retained considerable strength, while only private consumption and government consumption have slowed slightly in the year to date.

The somewhat less dynamic behaviour of private consumption in the first three quarters of 2006 is a result of the interplay of numerous factors whose effects, in some cases, have tended to counter each other. The losses of purchasing power caused by the high inflation rates in the first half of the year have affected household disposable income and, therefore, they will have tended to reduce consumer

spending. Further, the increase in borrowing costs following the successive rises in official interest rates by the ECB must have curtailed the spending capacity of some sectors of households. Conversely, intense job creation - running at a rate of over 3% - and the notable rise in household wealth are factors that should have sustained the growth of private consumption. Regarding household wealth, it should be pointed out that, although house prices have begun to show signs of slowing, there have continued to be very significant stock market rises in 2006, outpacing those in recent years, which were already considerable.

As I mentioned earlier, gross capital formation has been very robust throughout 2006. Its soundness has, moreover, been appreciable in all its components. In the case of investment in construction, growth rates of over 5% have been observed. In this respect, residential investment, along with the non-residential building and civil engineering works segments, were particularly buoyant. In the case of housing, the latest available data suggest that this dynamism might run into 2007. Investment in equipment has not only remained the most dynamic component of demand, but it also moved on a rising path in the first half of the year. This facet of the current growth pattern is, perhaps, one of the most favourable points, since it may be interpreted as a renewed effort by Spanish firms to extend and modernise their productive apparatus at a time at which returns are high and the financial conditions for undertaking such spending are still attractive. Evidently, increased export activity and the improvement in the industrial sector in 2006, which I shall address hereafter, are very closely connected to the momentum of investment in equipment.

The dynamism of exports is in fact one of the key features of the current economic situation, as it has served to raise the contribution of net external demand to GDP growth and offset the slight slowdown in national demand. The pick-up in goods exports has been driven by the forceful increase in world trade and by the take-off of economic activity in the euro area countries. This has led our export shares in international markets to stabilise somewhat, following the losses recorded in the two previous years. However, no substantial changes to the gradual deterioration in the price-competitiveness indicators seen in recent years are discernible yet. Combined with the buoyancy of final demand, this has meant that purchases abroad have retained strong momentum, whereby import penetration has continued to increase.

Despite the better export performance and the slowdown in expenditure, the external deficit has continued to increase both in nominal terms and as a percentage of GDP during the first half of 2006, albeit at lower rates than in the two previous years. The rise in the external deficit reflects, first, the impact of some temporary or one-off factors such as more expensive energy and the cyclical discrepancy between our economy and that of the euro area. We may also include here the import intensity of investment in capital goods, although this component may have a more permanent underpinning. Foreseeably, the recent course of energy prices and the recovery in the euro area will contribute to alleviating the tendency towards deterioration. However, we must not lose sight of losses in competitiveness. Reversing these losses may prove much more complex since that will ultimately depend on the economy's efficiency and flexibility.

The labour market has continued to be governed by the patterns of previous years, with strong job creation that has provided for the incorporation of a growing number of workers into the market and a reduction in the unemployment rate. As in past years, the dynamism of the labour force has been underpinned by a higher participation rate among women and continuing sizeable migratory flows. On Eurostat figures, the unemployment rate fell to the point of reaching the same level as the euro area average (7.8%) in October, a rate not seen in Spain since the 1970s.

The dynamism of job creation is linked to the relatively moderate rate of increase of compensation per employee seen in recent years. In any event, these figures should be properly analysed. Firstly, labour costs - which have risen slightly in the first half of 2006, standing at a rate of around 3% - are appreciably lower than negotiated wage settlements under collective bargaining agreements. When taking into account the effect of indexation clauses, these settlements exceed 4% in 2006. That means that the more moderate rate of increase seen in compensation per employee masks very relevant composition effects. Specifically, the sizeable inflows of new workers at low wage levels - with immigrants accounting for a significant portion - is alleviating the rising labour costs that would have stemmed from the rises negotiated in collective agreements.

Further, it is important to note that, when this relatively moderate trend of compensation per employee is combined with the low productivity of the Spanish economy, the result is unit labour costs that are continuing to grow at a higher rate than those in the euro area. The manufacturing sector, however,

has recently seen high productivity gains and some stabilisation of unit labour costs relative to the euro area countries.

Turning to inflation, we have seen two very different trajectories in 2006. In the first half of the year, price increases were very high, driven by labour costs and by widening margins, but especially by higher oil prices. The 12-month rate of increase of the CPI held at close to 4% until July, with a differential in relation to the euro area that at one point was 1.8 percentage points (pp), above the average differential observed since 1999.

However, the decline in oil prices that began in August has swiftly passed through to prices in the Spanish economy. As a result, the CPI rate stood at 2.5% in October, 1.4 pp below the July rate. That enabled the differential with the euro area countries to be cut by 1 pp, to slightly below the average in recent years. The improvement in underlying inflation was, however, very limited, and this variable is holding at a rate of close to 3%.

Admittedly, 2006 may possibly close with a growth rate somewhat higher than that of the previous year. But the outlook for 2007 points to a slight slowdown in GDP growth, as part of a continuation of the patterns in recent quarters I have described to you. National demand is estimated to hold on a mildly slowing path, and there will be further improvements in the contribution of net external demand. This profile would be in line with the macroeconomic scenario on the basis of which the State budget for 2007 has been prepared, although the starting point is somewhat higher growth rates in 2006. As to inflation, although the growth of the CPI in 2007 on average will be far below that of the current year if cheaper oil takes root, it is clear that there will only be significant headway in inflation rate convergence with the euro area if this reduction in energy prices feeds through permanently to agents' expectations.

We are therefore faced with a picture of sustained growth and some gradual correction to certain imbalances in the Spanish economy. Yet this scenario is not free from risks in the medium term. On the international front I have already mentioned risks relative to the outlook for the world economy and the uncertainty over the intensity of the European recovery. Furthermore, oil prices are subject to the influence of numerous economic and geopolitical factors, any changes in which may prompt a reversal of the fall seen in recent months. Within Spain, both the persistent inflation differential with the euro area and the high indebtedness of Spanish households harbour uncertainties that economic policy should contribute to dispel.

The maintenance of price increases higher than those in the euro area over a lengthy period is a cause for concern. Underlying inflation appears to have stabilised at a relatively high rate close to 3% in recent years. This persistence relates partly to the presence of factors that add inertia into the inflation rate, such as the indexing mechanisms in collective bargaining. The differential with the euro area is particularly high in the case of services, standing at around 2 pp. Against this background, the recent reduction in the inflation rate offers the perfect opportunity for this containment of inflation to be incorporated fully into the price formation process, providing for a moderation in expectations of price increases. That would allow it to have a lasting effect on future inflation and, thereby, we would see progress in the narrowing of our differential with the euro area. The lesser impact that the activation of the indexation clauses will foreseeably have in 2007, along with the fact that wage bargaining next year may unfold while the main inflation reference is at a rate of below 3%, substantially down on the related rate in the first half of 2006, should be conducive to such moderation. This improvement would, moreover, be important for further re-balancing domestic and external demand and ensuring the continuity of economic dynamism in the medium run.

In my recent appearance before the Lower House Budget Committee, I referred to the growing debt of companies and, in particular, of households as one of the sources of medium-term risk to the scenario of sustained growth and the tendency towards the re-balancing of the Spanish economy that I have set out today. Given the importance of the issue, I believe it would be useful to reiterate what I consider is a balanced analysis of this phenomenon.

The Banco de España has been on a vigilant footing regarding the rate at which corporate and, especially, household debt has been growing in recent years, particularly given that most of such debt is floating-rate. This tends to increase households' exposure to potentially unfavourable changes in their income or in the cost of borrowing. Such exposure may particularly affect those segments of the population whose room for manoeuvre in these situations is more limited. There is thus no reason for complacency.

A balanced analysis requires the joint assessment of all factors making up the household financial position. In this connection, it should be remembered that the payments associated with the debt incurred have grown at a substantially lesser extent than the volume of the debt and, at present, they account for a proportion of household income which, at the aggregate level, is still fairly moderate. The value of household financial and non-financial assets has also risen considerably in recent years. That is due in particular to the property market boom, on which the recent structural changes in the economy, including immigration, have had a bearing. Consequently, the financial position of the sector as a whole is fairly sound.

The trend of indebtedness in the past ten years has been sufficiently significant as to identify it as one of the risks to consider in the essentially favourable scenario of the Spanish economy. The Banco de España should signal this fact, particularly in a setting in which credit continues to show signs of being very buoyant. But, at the same time, we cannot ignore the fact that the financial position of households and firms is healthy and provides a sound basis for adaptation to the interest rate levels in keeping with the recovery in economic growth in the euro area. The solvency of the Spanish financial system is a further guarantee for the maintenance of stability in the economy as a whole.

In sum, the outlook for growth in the Spanish economy in the coming quarters is, in my view, relatively healthy. And economic policies can contribute to providing continuity to this expansion in the medium term, defusing some of the risks highlighted. In that connection, it will be essential to restrain demand impulses and improve supply-side functioning.

The change in the ECB's monetary policy stance is not only useful for sustaining the recovery in the euro area in a manner which is compatible with price stability, but is also beneficial for the Spanish economy, since the least easing of monetary conditions is conducive to containing domestic demand and helps re-balance the expansion.

Spanish public finances, for their part, remain very healthy. On the latest official forecasts, the general government budget balance will run a surplus of 1.1% in 2006, 0.2 pp up on the figure set in the last Stability Programme update. A balance on this scale obviously complies comfortably with the European fiscal discipline rules in the Stability and Growth Pact. Moreover, it will allow for a further reduction in the public debt/GDP ratio, possibly to below 40% of GDP at the end of the current year. In view of the figures available for the budget outturn during the first three quarters of 2006, it seems very likely that the final balance will be above the latest official forecast.

The sound fiscal position reflects the fact that revenue from the main taxes has amply exceeded the estimates made in the budgetary programming exercise, which can be explained only in part by the higher-than-forecast economic growth recorded.

The draft State budget for 2007 sets a surplus target for the overall general government sector of 0.7% of GDP, under a macroeconomic scenario marked by a slight slowdown in GDP. True, various factors will tend to diminish revenue in 2007, such as the entry into force of the personal and corporate income tax reform, the new EU financial perspectives and certain aspects of the labour market reform applied last July. But if we take into account the better-than-estimated closing budgetary balance in 2006 and the continuity of the economic boom scenario, revenue should foreseeably continue to be buoyant, enabling the surplus target set in the draft budget for the coming year to be exceeded. Achieving a higher-than-forecast budget surplus would also be favourable both from the standpoint of the Spanish economy's conjunctural situation and from a medium-term perspective. In this respect, a budgetary consolidation drive would contribute to setting in place the right foundations for tackling the challenges posed by ageing and the commitment to meet the requirements arising from protection in situations of dependency.

In the budget for 2007, some expense items have been accorded particular attention, such as those aimed at improving productivity; in this connection, the resources earmarked for education and innovation and for investment in infrastructure have been increased. The priority given to these items is most appropriate, given the poor productivity figures witnessed. Yet what is important is to ensure the efficiency of the measures undertaken, so that increased resources effectively translate into actual improvements in the Spanish economy's capitalisation and productivity in the medium term.

Improving the efficiency of expenditure management by the different tiers of general government is also a vital requirement for maintaining a healthy fiscal position. This is a challenge that calls for the involvement of all levels of government. From this standpoint, it is very important to adapt the analysis of public finances and its economic policy implications to the current Spanish situation, marked by highly decentralised public spending. Leaving aside the transfers between different tiers of

government and interest payments, which reflect past financing patterns, the volume of spending by territorial governments is almost two and a half times that within the State sphere. Such a figure shows the enormous increase in the role of these agents, which has significant consequences for budgetary policy conduct, both in terms of its contribution to macroeconomic equilibrium and as regards its influence on the economy's growth capacity in the medium and long run.

From the standpoint of the contribution to macroeconomic equilibrium, the initial data on the regional governments' budgets for 2007 point to a balanced budget target for the year. We might wonder, however, whether the macroeconomic situation I have described, at a cyclical juncture marked by a prolonged expansion, would require the setting of somewhat more ambitious targets, in line with the spirit of the new Budgetary Stability legislation, even though these are only legally binding as from the 2008 budget. Also, from the standpoint of their contribution to long-term growth, the role of the territorial governments in managing the public spending items of most relevance for improving the Spanish economy's competitiveness acquires considerable importance. Illustrative of this point is the fact that the territorial governments are responsible for more than 90% of public spending on education.

As regards supply-side policies, the main thing is to bring about an improvement in the capacity of the economy, its agents and its markets to adapt, which enables them to respond flexibly to a changing and highly competitive environment. Better supply-side functioning would help square the continuation of the current strong employment generation with the attainment of productivity gains. The National Reforms Plan lays down a series of measures geared in this direction, and they should be resolutely applied. Moreover, there are areas such as the labour market where it is still necessary to push through reform measures to increase flexibility and efficiency, harnessing the current good times to adopt reforms that will prevent a cyclical change from causing job destruction as occurred in the past.

The picture that emerges from the recent information I have set out is that of an economy which continues to show signs of high dynamism, with the prospect of this continuing - with somewhat less momentum - in the coming years. Yet this favourable situation prolonging an exceptionally long upturn should not be understood as signifying the absence of problems in the medium term. On the contrary, over a longer horizon the Spanish economy will have to face major challenges in competitiveness, productive efficiency and the flexibility of the markets for goods, services and factors. Integrating new labour force entrants into the labour market will have to be compatible, moreover, with improved productivity. In this connection, it will be necessary to better incorporate technical progress and innovations into business and general government activity, and to enhance human capital skills. Likewise, prospective demographic developments will pose significant demands in respect of pensions and protection in situations of dependency. This will all call for further policies geared to re-balancing the sources of growth and stepping up the reform agenda in order to dispel the risks that are emerging and to ensure the continuity of the ongoing improvement in well-being in the medium and long-term.