

Miguel Fernández Ordóñez: Momentum of the global economy and the recent turbulence on the financial markets

Testimony of Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, to the Parliamentary Committee on Financial Affairs, Madrid, 18 September 2007.

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Ladies and gentlemen,

My appearance before this Committee comes at a juncture characterised by two notable phenomena. First, the continued strong momentum of the global, European and Spanish economies for yet another year. And second, the sudden emergence of uncertainty in the world economy as a consequence of turbulence on the financial markets.

The root cause of this turbulence is the increase in US sub-prime mortgage loan defaults. The distinctive feature of these loans is that they have been granted to individuals with incomplete, or even inexistent, credit records illustrative in all cases of a high risk profile. These loans have, moreover, often been extended under rather lax conditions and hence have ultimately put the US institutions involved in a highly vulnerable position.

When the (in all likelihood excessive) risk exposures materialised, the intermediaries specialising in mortgages of this type began to incur losses and some of them were unable to meet their payment commitments. In the early stages, then, the crisis was confined to a limited number of specialised US financial intermediaries.

However, the weight of the US economy in world events, the high volume of funds attracted by it in recent years on the international markets and, above all, the strong interdependence that has developed between these markets and between financial institutions worldwide as a result of globalisation, have ultimately resulted in the financial turbulence taking on a global dimension.

A key factor in propagating the turbulence internationally has been the prolific development in recent years of new structured financial instruments designed to smooth the transfer of credit risk between different agents. These new assets enable greater diversification of banks' loan portfolios and therefore more efficient management of underlying risks. On the downside, however, there are also potential adverse effects owing to the valuation difficulties derived from their complexity and to the weak incentives for institutions specialising in these practices to properly calibrate risks that they may not ultimately assume. I shall return to this point later on.

The spread of the turbulence throughout the international system brought falling valuations and rising volatilities in a good number of stock markets, along with a general increase in the credit risk premiums demanded in fixed-income markets. These movements reflect a trend towards the more accurate pricing of risks following a long period of excessive indulgence, and this should make for sounder economies in the medium and long term. Nevertheless, the correction is causing tension in lending conditions which, if it persists too long, could also bear on the confidence of investors and other economic agents.

However, it is still premature to assess the effect of these shocks on world economic growth. Significant data are not yet available on how economies have performed after the shock. In any event, the size of the possible effect will depend closely on how much the US economy is affected by the turbulence that has arisen there. The information available so far shows that the United States is more resilient to the residential investment crisis than originally envisaged, so the foreseeable effects seem limited. This diagnosis is consistent with the forecasts of international organisations which, while acknowledging a considerable heightening of uncertainty and downside risk, continue pointing to a scenario of ongoing world buoyancy. Realistically, however, if the United States went into recession, a significant

change in the world economic scenario could take place, although the impact would in any event be cushioned by the continued buoyancy of the emerging economies, which have generally been little affected by the financial turbulence.

The extent of the impact on global growth will also depend fundamentally on the force and duration of the shocks generated. In the past, in episodes such as that of 1998 sparked by the collapse of the Long Term Capital Management fund and by the Russian debt crisis, the financial turbulence barely influenced world economic buoyancy despite the dark predictions that accompanied it. Other episodes, by contrast, such as the “new economy” crisis had a more far-reaching impact, albeit of varying intensity and duration in the different geographical areas.

Unfortunately, these experiences are no precedent for diagnosing the potential scope of the current episode, which exhibits many new features, including the fact that it is especially concentrated in the Western heartland of the industrialised countries. The recent past has seen turbulence in Asia, Latin America and eastern Europe. Now, in contrast, the shocks are mainly affecting the United States and the more developed European countries.

Let me thus take an eminently European perspective as I examine more closely some of the main features at play here. This approach will also help me to look at its implications for euro monetary policy, which I believe is the most logical way to address the possible impact on the Spanish economy.

I wish to begin by emphasising the non-existence in the euro area of the sub-prime mortgages that are accepted practice in the United States. Therefore, in the first analysis, the rise in doubtful assets in the United States should affect only the European financial intermediaries that acquired securities linked to sub-prime mortgage loans originated in that economy. However, the propagation of contagion is not confined to the influence of this channel alone, but rather is transmitted through a wider range of shocks.

The increase in doubtful assets and defaults in US mortgages has set in motion a global process of upward revision of credit risk premiums, which in the climate of economic boom of recent years had sunk to very low, barely discriminatory levels, prompting what was probably excessive investment in potentially high-risk activities.

These investments were further driven by the proliferation of new financial intermediaries specialised in the credit risk transfer markets to which I referred earlier. In particular, in the current bout of turbulence a major role has been played by institutions that raise funds by issuing very short-term fixed-income securities and use the proceeds to acquire structured products linked to long-term loans, including US sub-prime mortgages.

The liquidity risks associated with such practices have been clearly under-estimated by these specialised institutions. And the consequences have been felt in the money markets because some credit institutions agreed to provide liquidity to these specialised institutions if, upon maturity, the latter did not manage to roll over the funds raised via the issuance of securities. This led to a serious liquidity crisis in the money markets of a good number of industrialised economies, including the euro area.

Central banks, and the ECB in particular, reacted rapidly and implemented emergency processes to inject the amounts of liquidity demanded by the market. This prevented the lack of liquidity from compounding the crisis and sent a message of calm and reassurance to the markets.

However, the difficulties in pricing the structured products linked to sub-prime mortgages and, above all, the patent lack of transparency in the process of pooling, segmentation and redistribution of credit risk carried out through these products are causing problems of confidence between institutions.

All these problems have practically paralysed the interbank markets for term loans, in which transaction volumes are very low, and led to interest rates above those expected under

normal circumstances. European stock market prices, particularly for financial and construction firms, have also been adversely affected, while some investors have shifted to lower-risk assets such as government debt, resulting in declines in yields on these securities.

The uncertainties deriving from all these movements pose evident added complexity in monetary policy decision-making.

Fortunately, the financial turbulence described reaches Europe at a time of high economic buoyancy and, therefore, notable resilience in the euro area. The GDP of the euro area grew somewhat less than expected in the second quarter of the year, but 2007 to date represents, overall, a continuation of the economic boom initiated in the area in mid-2005. The sound financial position of firms, the expected profit rates and the favourable response of employment to the step-up in activity suggest that this stage of output expansion will persist over the coming quarters at a rate that, although it may well be slightly lower than anticipated some months ago, continues to be around potential growth. It should be kept in mind that the persistence of certain global imbalances and protectionist pressures and the uncertainties over oil and other commodity prices represent risk factors for growth, which date from before the outbreak of the current bout of turbulence.

Turning to prices, the behaviour of production seems to have been accompanied by a slight upturn in inflation to around 2% in the medium term, since the smaller contribution of indirect taxes (which has been especially marked in 2007) should be offset by the larger contribution of unit labour costs, in what is a buoyant labour market. Against this background, a possible increase in wage pressure associated with the aforementioned taking-up of slack in the labour market, or a widening of the margins in those sectors more sheltered from international competition, pose risk factors for price stability in the euro area.

The current financial market turbulence has naturally heightened the downside risk to growth, and this has in some way mitigated inflationary risks, which nevertheless continue to rise. Above all, however, the turbulence has widened the range of uncertainty associated with the central scenario for the European economy that I have just described.

In these conditions, the first ECB Governing Council meeting this month unanimously decided, as you know, to hold interest rates unchanged and gather more information on this episode of turbulence and study it in more detail before taking any new decisions. It should come as no surprise to anyone that the conditional nature of the decisions, which has always been a significant feature of ECB monetary policy practice, should take on particular significance in the current setting of particularly high global uncertainty.

Hence in the coming months the main channels through which financial shocks could affect the European economy will have to be monitored very closely. In my opinion, three factors require particular attention. First, it is necessary to gauge the true extent of the US slowdown, its possible spread to the world economy and the possible impact on exchange rates. Second, at the European level, the effect of the turbulence on the cost and availability of financing for the private sector will have to be calibrated. Finally, the possible impact on corporate and consumer confidence will have to be monitored carefully. The signs identified in these latter two channels, i.e. credit and economic sentiment, will be particularly informative for euro area economic growth when they affect countries in which consumption growth is still somewhat hesitant.

I also believe that, echoing the words of the ECB President after the Governing Council meeting, this is an appropriate time to reiterate the firm commitment of monetary policy to the objective of price stability, which is the best way to promote the sustained growth of output and employment and thus the welfare of European citizens in general and of Spaniards in particular.

In fact, these events have taken place at a time when the Spanish economy, too, continues to show considerable buoyancy that is prolonging its already long expansionary phase. Output grew in the first half of this year at a rate of around or slightly above 4% (in line with

the performance in the closing months of 2006) and the vigour of activity was compatible with a more even balance between domestic and foreign sources of spending. In particular, the contribution of net external demand, which trimmed two percentage points from growth in certain months of 2004 and 2005, improved in 2006 and continued to do so in the first half of this year. At the same time, the share of business investment in domestic demand has continued to rise at the expense of private consumption and residential investment.

The process of normalisation of monetary and financial conditions that commenced at the end of 2005 has contributed effectively to achieving this more balanced composition of spending. Moreover, the healthy performance of the world economy in 2006 and, in particular, the recovery of the euro area have spurred exports after several years of weakness. On the supply side, the growing availability of labour resources in a highly expansionary demographic setting helped to smooth the adjustment of activity to this robust demand, preventing excessive cost and price pressure from building up. Indeed, the inflation rate fell to around 2% (2.2% in July and August), taking the differential with the euro area to half a percentage point, although some rise can be expected in the rest of the year and in the first quarter of next year.

The smoothly slowing path of household consumption in 2006 and the first half of this year reflects, as mentioned above, the foreseeable adaptation to more normal monetary and financial conditions. The rise in interest rates that began at the end of 2005 has been spreading gradually to the various financial and banking markets, stimulating household saving and increasing the interest burden on indebted households. Also, the lower rates of household wealth appreciation (mainly due to the gradual containment of house price rises) have reduced the expansionary influence of wealth effects on consumption. Counterbalancing this, the strength of employment, which continues to grow at more than 3%, and the high levels of confidence have played a significant role in ensuring that this process of adjustment of household consumption to more sustainable levels has been smooth.

Also perceptible since the beginning of 2006 has been the lesser vigour of residential investment which, as in the case of private consumption, was also in response to the interest rate rise and to the lowered expectations of house appreciation following the sharp price increases of previous years. In this case, the gradualness of the residential investment slowdown was made possible by the support provided by strong housing demand, against a backdrop of high demographic momentum in the Spanish economy in recent years.

The lower contribution to growth of these two domestic expenditure components was offset, first, by the continued buoyancy of productive investment of firms, in a situation of high profitability and favourable business expectations due to the continued momentum of domestic demand and, above all, to the surge in the world economy. In particular, capital goods investment in 2006 grew by more than 10% and in recent quarters its rate of expansion has been around 13%. Furthermore, net external demand has helped to mitigate the impact of the slowdown in household spending on growth, thanks to the notable recovery of exports in 2006 and to the moderation in imports in the first half of this year.

The most probable scenario for the coming months is the continued gradual moderation of domestic demand and of output growth. In fact, there were signs in 2007 Q2 that might suggest a gradual change to a more subdued growth path, although GDP growth was only 10 bp less than in the first quarter of the year. The information (still very partial and fragmentary) of certain economic indicators relating to 2007 Q3 also points in this direction.

In light of the buoyancy of domestic demand in recent years, it is reasonable that private consumption and residential investment should show somewhat lower growth rates, although, as has been the case so far, a continued robust employment and population growth rate would fairly effectively counter the possible deceleration of these two variables. In the construction sector, moreover, investment in civil engineering and in non-residential building, which has so far shown greater resilience, will foreseeably remain vigorous in the

next few years. This could soften the negative impact on growth caused by the slowing of residential investment, where a cyclical downturn seems to have started.

Productive investment will probably continue to be the most buoyant component of domestic demand, although it is hardly likely that it alone will offset the lower contribution of household spending. Therefore, the role of net external demand will be fundamental in ensuring that a certain containment of expenditure is compatible with continued growth of around 3%. The contribution of this variable will hinge crucially on the behaviour of Spain's export markets, but also on competitiveness, which is a factor that firms and the economic authorities are actually able to influence.

In this respect, the basic channel through which the recent episode of financial instability and heightened international uncertainty could affect the Spanish economy's expected growth scenario depends on the performance of the foreign sector. Indeed, if that episode significantly affected the buoyancy of Spain's international markets, the capacity of external demand to contain the negative impact of the slowdown in private spending would be diminished.

The Spanish economy's track record over the last few years shows that the behaviour of employment and its influence on household income expectations play a key role as drivers of household spending. For this reason, it is essential that resource allocation mechanisms should be sufficiently flexible to enable industrial and service activities (partly linked to exports) to play a greater role and take up the baton from construction.

From the standpoint of the continued dynamism of domestic spending, attention also has to be paid to how the Spanish economy may be affected by a possible tightening of financial conditions stemming from developments in European financial markets, a process in which a fundamental role is played by the behaviour of Spanish financial institutions. Allow me, therefore, to devote special attention at this point in my address to the current situation of Spanish credit institutions, which stand at the heart of our financial system.

Spanish credit institutions face this bout of turbulence from a position of strength based principally on high profitability, which is always the first line of defence against any adverse shock; comfortable solvency levels clearly above the minimum regulatory requirements; and, standing at some point between the two, the ample coverage of doubtful assets by the provisions that have been built up during the boom years. I believe that the role played by the Banco de España in promoting this accumulation of provisions is well known, so I shall not dwell on this point.

I will, however, point out that there are various idiosyncratic factors in the performance of Spanish institutions that have limited their exposure to the current shocks. I have already mentioned that in the euro area there is no equivalent to the US sub-prime mortgage market, an observation that applies fully to Spain. Rather, the credit quality of Spanish mortgages is high, as shown by the low doubtful assets ratio and the moderate levels of the average loan-to-volume ratio and of the collateral required.

Along these same lines, the weight of the assets linked to the sub-prime mortgages on institutions' balance sheets is completely marginal, as is also their indirect exposure through any lines of credit granted to other financial intermediaries that may actually hold such assets. The fact is that intermediaries of this type have not proliferated in Spain's financial system.

One of the factors that has probably contributed most to preserving the quality of assets in the Spanish financial system is the persistence of a traditional banking model in which, unlike in other countries (especially the United States) in recent years, institutions have used asset securitisation mainly to fund the expansion of activity and not to transfer to third parties the risks associated with their loan portfolio. One particularly positive effect of this pattern of behaviour in the current situation is that the institutions' practice of keeping credit risks on their own balance sheets has acted as a powerful incentive for them to ensure that their risk

quality controls continue to work properly. Also, since the securitisation processes used by Spanish institutions have aimed to raise fresh funds rather than redistribute risks, instruments such as covered bonds or asset-backed bonds have been used, which are not very complex and are much easier to price than the structured products that have proliferated in other parts of the world.

These sources of solidity should not lead us to overlook the danger that an excessive prolongation of the current bout of turbulence could ultimately have undesirable effects on investor confidence. These effects might extend above and beyond a desirable and healthy correction of abnormally low risk premiums and volatility levels, and substantially reduce the capacity of financial markets to offer useful yardsticks by which investors can discriminate the true credit quality of the different instruments. If this were to happen, the need for the Spanish economy to turn to the international markets to finance a large part of the investment spending of Spanish households and firms could become an obstacle to continued high buoyancy in the future.

Overall, ladies and gentlemen, since I last appeared before you, the growth prospects for the Spanish economy that I then described largely remain in place, although the financial turmoil has, as everywhere, heightened the uncertainty surrounding those prospects. The outlook offered by a scenario of continued buoyancy – albeit at a slightly more moderate rate but with a more balanced composition – and the solidity of our financial institutions are evidence of a strength that affords every assurance of being able to withstand the impact of the turbulence. However, depending on the ultimate duration and intensity of this episode of turbulence, it cannot be ruled out that some difficulties may arise to prevent external demand from acting, as it has to date, as a factor sufficient to offset the foreseeable gradual moderation of domestic demand. This will be even more the case if the impact of the financial instability on the growth of Spain's main export markets becomes substantial.

In circumstances such as those prevailing at present, economic policy has a very important role to play in offering a framework in which confidence stems from the existence of leeway for taking action to deal with possible future contingencies. To this end, policy should maintain its firm stance on medium-term stability targets and consequently avoid the adoption of measures excessively focused on the short term. In this respect, budgetary policy should not change its current stance, which is proving so beneficial for the strength of the economy by preserving a sufficiently wide budget surplus, so that there is headroom to deploy, if needed, its stabilising potential in less favourable circumstances than those prevailing at present. For this purpose, spending deviations should be avoided, since they would absorb prematurely a part of that headroom at a possibly inappropriate time. We will have occasion to look more specifically at this topic in the framework of the budget discussion process.

An equally important task is that of continuing to implement resolutely and ambitiously the structural reform agenda, both in making the goods and factor markets more flexible and in pushing ahead with the capitalisation, productivity and competitiveness of the economy. These reforms are essential in the current circumstances because they are needed to enable resources, such as labour, to be reallocated without friction between sectors and to improve the conditions under which Spanish production competes in the international markets.

Thank you.