Miguel Fernández Ordóñez: Recent developments in the Spanish economy

Testimony of Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, before the Parliamentary Budget Committee, Madrid, 6 October 2009.

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Ladies and Gentlemen,

I appear before this Committee as part of the parliamentary discussion of the State Budget for 2010. For the first time in the past two years, we are at a juncture where incipient signs are emerging that the global economic and financial crisis is stabilising. This can be deduced from the macroeconomic projections by various international agencies in recent weeks, which indicate that the dynamic of successive downward revisions of GDP growth has come to a halt, and that in some areas there have even been upward revisions.

Part of this improvement is in response to the aggregate demand stimulus and financial system support policies which, undoubtedly, have acted to offset the enormous contractionary impulses experienced and to stabilise the financial markets. Notwithstanding, uncertainty over economic and financial developments in the coming quarters remains high.

At times like the present, the task of economic policies becomes vitally important to ensure that the recovery has sufficiently sound foundations. In the Spanish economy this task is particularly significant, since although recent data also point to an easing in recessionary trends, both the downturn in employment and the rapid deterioration in public finances shape a situation laden with challenges and difficulties. We are at a crossroads where economic policy action may be decisive in setting us once more on a path of growth and increasing well-being.

My testimony today, as part of the Parliamentary discussions on the Budget, offers me an opportunity to analyse the role budgetary policy should play and the need for this policy to be underpinned by a series of structural reforms that remove the obstacles to a recovery in economic activity, in employment and in public finances. I shall begin with a brief reference to the international setting and to the economic outlook for the euro area. It is well known that these settings determine the behaviour of monetary policy. Regarding this latter point, allow me to remind you that the ECB Governing Council will meet later this week; accordingly, my appearance here is during what we call purdah period, and my comments should not be interpreted, under any circumstances, as a prelude to or anticipation of the monetary policy discussions or decisions at this meeting.

After several quarters of continuous deterioration which led the world economy to the biggest contraction since the Second World War, the latest economic indicators are beginning to point to a pick-up in activity and in international trade, which is more evident in the emerging than in the more advanced economies, where the signs of improvement are somewhat more incipient.

These signs are not unconnected to the swift and resolute intervention by the public authorities, which has proven effective in checking the growing perception of risks on financial markets and in increasing agents' confidence, thereby playing a valuable role in containing this crisis.

But it is precisely now when the results of the measures are coming to fruition that it is most important to shun complacency and untimely and excessive optimism, which might curtail the process. The latest forecasts from the IMF and from many other supranational institutions admittedly include upward revisions of world output growth rates in 2010; but they also emphasise the persistence of a high degree of uncertainty. This applies in particular to financial market developments, where certain tension indicators still remain at high levels.

It seems reasonable under these conditions that the most immediate objectives of the economic authorities should continue to focus primarily on restoring the orderly working of financial markets and on maintaining the aggregate demand stimulus policies until economic recovery takes firm root, as was recently reiterated at the Pittsburgh G-20 Summit. Further ahead, however, the main challenge will be to identify the appropriate time for withdrawing the exceptional measures that have been adopted in the financial, fiscal and monetary realms, avoiding both a premature withdrawal that might undermine what has been achieved and an unnecessary prolongation that might ultimately generate dynamics that are difficult to reverse, and that are harmful to growth and well-being. The complexity of such a process means it is necessary to design forthwith efficient exit strategies, so that they may be implemented when the time is right.

The euro area also shares, albeit to a lesser extent than other zones, these signs of incipient improvement. The latest economic data have been less adverse than expected and the quantitative and qualitative indicators coming to light point to a stabilisation of activity in the very short term which, according to the ECB's projection exercises, will be followed by a presumably slow recovery that will not be free from difficulty.

Public finances have deteriorated considerably as a result of the operation of the automatic stabilisers, the discretionary measures to stimulate aggregate demand and action to shore up the financial system. In turn, the financial crisis and the fall-off in activity have severely affected certain European banks, which depend in part on public sector support and which remain subject to a deleveraging process whose scope is still not readily discernible.

On the prices front, the risks of deflation have diminished substantially. Although the strong easing in commodities prices until mid-year meant that inflation turned negative, there is a broad consensus, of which the ECB is part, that anticipates inflation will resume positive levels towards the end of the year. Such levels would, however, be moderate for a relatively lengthy period, against a background marked by considerable slackness in productive capacity which will help contain potential inflationary pressures.

The benchmark interest rate in the euro area, at 1% since last May, has proven appropriate in a setting in which inflation expectations have remained anchored and in which the effects on the economy have been complemented, moreover, by those of the various exceptional measures adopted by the ECB Governing Council since October 2008. Such measures included most notably the unlimited provision of liquidity to the banking system at terms extending up to one year and a programme for the outright purchase of mortgage bonds and other similar securities issued in the euro area.

Moving now to the Spanish economy, it is clear that the acute international financial crisis and recession in the main areas of the world fed through with great intensity to Spain, exacerbating the correction of the real estate market that had begun previously and prompting rapid job destruction. The fact that the powerful external contractionary trends coincided with the internal adjustment needed after a long expansionary phase has led to a decline in economic activity that is unprecedented in recent decades.

On the data available, output fell by 4.2% year-on-year in the second quarter of 2009 as a result of the marked sluggishness of national demand, particularly private spending. Only the public-sector components of demand have held at positive growth rates, and in the case of public investment this was due above all to the roll-out of the Local Investment Plan last April. The strong contractionary impact of the decline in domestic spending on economic activity has been cushioned, however, by external demand. That said, the positive effect of foreign trade has been the consequence, above all, of the substantial cut in imports, since exports – despite improving their market share – have also been affected by the sharp decline in world trade.

Fortunately, the latest figures for the Spanish economy indicate that, as in the euro area and in the rest of the world, the sharpest phase of the contraction is now behind us. The decline in activity in the second quarter was still substantial (1.1%), but more moderate than in the first quarter (1.6%). As in other areas, the main conjunctural indicators are beginning to show signs of more modest declines or of stabilisation, suggesting that the virulence of the crisis has continued to abate in the third quarter of this year.

The recession is also correcting some of the main imbalances that built up in the Spanish economy during the boom period, mainly high private-sector debt, the excessive weight of the real estate sector and a persistent inflation differential, which translated into a growing external deficit.

The growth rate of credit to the private sector has fallen substantially and will probably continue to do so in the coming quarters. Such developments in lending correspond to what might be expected – in circumstances like the present – of its usual cyclical pattern, exacerbated by the tension on international financial markets. Conceivably, household and corporate debt ratios, which increased rapidly during the expansionary phase, will continue the adjustment on which they have embarked in recent quarters, and this requires that agents' debt should grow for some time at a rate below that of income generated.

The strong concentration of resources in the real estate market is also being corrected, with a very swift decline in new housing starts, although this has not prevented the emergence of a sizeable housing overhang and downward pressure on prices as the fall in demand has also been very sharp. Nonetheless, cuts in interest rates and in house prices have placed housing affordability indicators at more moderate levels, which will help boost house purchases.

Similarly noteworthy is the reduction in the inflation rate in Spain in recent months, which is proving more marked than in the euro area. This decline is underpinned not only by the greater effects induced by the course of oil prices but also by the fall in the prices of industrial goods and in the notable easing in services prices, which are growing below 2%, after having held at a persistent rate of increase of around 4% for many years. It would be most beneficial for the economy to seize this opportunity to make the appropriate reforms to services markets, so that this pattern in moderation may be maintained when household expenditure picks up.

The strong adjustment in spending is also manifest in a rapid reduction in the external deficit, which may have halved by 2009 from its level of close to 10% of GDP in 2007. Ideally, however, the spillover effect of the weakness of national demand on imports should be reinforced by a strengthening of the export base through the improved competitiveness of our companies.

But we should not lose sight of the fact that the correction of these imbalances is coming about through a severe contraction in output that is exerting a most adverse effect on employment, as a result of the problems present in the functioning of the labour market, and on public finances.

Job destruction, which was concentrated in the second half of 2008 in construction, subsequently spread both to industry and to market services, affecting temporary contracts most especially. After the sharp drop in employment in the closing months of 2008 and early 2009, the pace of job destruction has slackened, largely due to the effects of the launch of the Local Investment Plan. And since the dynamism of the labour force has held up well into 2009, the unemployment rate has skyrocketed from 8% in 2007 to almost 18% in the second quarter of the current year. The sharp employment adjustment has prompted a rise in apparent labour productivity from a rate below 1% in 2007 and the previous years to more than 3% in the second quarter of 2009. Unfortunately, these productivity figures are not the outcome of genuine improvements in the efficiency of productive processes, meaning they will hardly be sustainable in the medium term.

The fact that labour costs are still growing at a high rate in this situation (on National Accounts figures wages increased by 4.6% in the second quarter of 2009) while employment was declining at a rate of over 7% and inflation was negative, reveals once more the persistence of serious inefficiencies in the behaviour of our labour market.

The outlook for the Spanish economy remains highly uncertain, albeit less so in recent months in light of the likely recovery in the world economy in 2010. The Spanish economy will probably continue posting declines in output in the second half of this year, in contrast to the modest pick-up in activity expected in the euro area. Bearing on this different behaviour will be the marked weakness of investment, not only in the case of housing, given the supply overhang, but also probably in that of corporate investment, since low capacity utilisation allows increases in demand to be addressed without having to undertake new investment projects. Nor will it seem feasible to increase public investment in 2010, following the intense effort made in 2009, linked largely to the above-mentioned Local Investment Fund for Employment.

How private consumption will fare is much more difficult to predict. Although the main determinants – such as the behaviour of employment – will not be favourable, the high level of the household saving rate makes it conceivable that, if the factors of uncertainty were to progressively dispel, consumption might recover significantly.

The main factor underpinning activity in 2010 should therefore be the external sector. The fact that the recovery in the Spanish economy lags that in the other European countries somewhat may provide for more expansionary behaviour of exports, whose trajectory has been reasonably positive.

Foreseeably, then, a gradual growth phase based on recovery in the external sector and on the progressive extension of its impulses to business investment and employment will begin over the course of next year, laying the bases for a demand-led expansion. However, as a result of the spillover effect of the negative 2009 rates, average growth in 2010 might post a moderate decline.

This trajectory of slow recovery in activity broadly matches the government's macroeconomic projection that acts as a basis for the State Budget for 2010. Yet as I said, there is a risk that business investment may perform somewhat worse than foreseen in this scenario.

But in my view, what is most important at present is not the exact date on which activity will begin to post a positive rate or whether its rate of increase will be greater or less than forecast in 2010; rather, it is the scale of the medium-term challenges involved in exiting the most complicated situation the Spanish economy has faced in recent decades. To entrench the recovery will necessarily require absorbing large numbers of unemployed; the reversal of unemployment's harmful effects on confidence and public finances; restoring health to the financial position of households and firms; and, in sum, the restructuring of a growth model that was not sustainable, especially under the new conditions created by the international crisis. And, as I have reiterated on many occasions, to do this it will be vital to adopt ambitious measures and reforms.

The economic policies pursued since the start of the crisis have focused, logically, on countering the contractionary forces at play, and the efforts deployed have contributed to lessening their impact. But now the slump phase has bottomed out and there are signs of a possible stabilisation, we must adopt an approach geared to absorbing the most negative effects of the crisis, such as the high level of unemployment and of the budget deficit, by addressing the structural problems of the Spanish economy so as to restore its growth potential and to prevent the risk of a scenario of prolonged economic slackness from materialising.

The demand-side policies pursued to combat the economic crisis have been very energetic. The cuts in official interest rates by the ECB have fed through to interbank markets and to credit transactions, and although borrowing conditions remain very tight, as a result of the upward revision of credit risk, the decline in interest rates is undoubtedly contributing to alleviating the financial pressure on the private sector. Moreover, these measures will continue to have significant effects in Spain in the coming quarters, given the prevalence of floating rates, which will continue alleviating the burden of debt for households and firms.

Fiscal policy has also contributed to cushioning the decline in activity by means of a most substantial budgetary drive, one greater than that in other developed countries. The effect of the numerous activity-supporting measures adopted in the past two years, along with the impact on public finances of the far-reaching cyclical downturn and with the loss of the extraordinary tax revenue from the real estate boom during the expansionary phase, have prompted a most rapid and sharp increase in the budget deficit. On the latest official figures announced by the government, the budget deficit could climb to around 10% of GDP at the end of this year, an unprecedented level in our recent history.

And the outlook for the deficit, in the absence of ambitious measures, is a complex one. True, some of the budgetary measures adopted were designed to be temporary, meaning that once the period they are in force expires, the budgetary situation ought to improve. Yet the cyclical change will take time to exert positive effects on public finances, as the path of recovery of activity in 2010 will still be weak. But what is important is to realise that the deficit generated over these two years has a significant structural component, given that current primary public spending has maintained a high growth rate and the sizeable extraordinary revenue linked to the real estate sector has been lost for good.

The deterioration in the fiscal position is manifest in a strong increase in public debt. As our own experience shows, the dynamic of rising indebtedness can prove difficult to break, especially when it is inconceivable that we can count in the future on some of the factors that significantly helped reduce debt in the past, such as interest-rate cuts and high economic growth over a very lengthy period.

Overall, all these factors increase the risk that, in the absence of corrective measures, the fiscal position will continue to worsen. Further, they lead to the conclusion that the room for budgetary policy to expand has been completely exhausted, and that it is vital that a credible strategy of budgetary consolidation be adopted for the medium term. If not, the increase in public debt and its influence on the net borrowing costs of our economy, and even on the very soundness of the financial system and its capacity to properly channel resources, may become a very heavy weight holding back our possibilities of recovery.

Given the fiscal imbalance that has built up, the scale of adjustment needed is most sizeable and will therefore require the adoption of highly ambitious measures on all budgetary fronts. It will be constantly necessary to strike a difficult balance between appropriately signalling the commitment to budgetary stability and, at the same time, not curbing the path of economic recovery. Past experience shows that the success of fiscal consolidation strategies hinges largely on their composition, so that cuts in public spending, especially non-productive spending, play an essential role in reducing the deficit. Unproductive spending, both on consumption and investment, should therefore be particularly scrutinised and monitored. In any event, when structural distortions have become considerable, certain elements of the tax structure have inevitably to be revised. Here it is vital to fully preserve efficiency in agents' saving and investment decisions, so that long-term growth prospects are not compromised. Selecting tax measures is never easy, and less so when the tax base is being eroded; consequently, tax instruments that cause least distortion should be used. In any case, we should ensure that increases in tax revenue are actually earmarked to reducing the budget deficit and not to financing potential spending slippages.

The government has announced its intention to resume deficit levels compatible with stability in 2012, in line with the horizon defined by the European authorities in the application of the rules of the Stability and Growth Pact. The State Budget for 2010, the first to be prepared under this general consolidation strategy, confirms this commitment. It is along the lines required to give credibility to the process, although to ensure that the budgetary targets are realistic, all economic agents must be convinced that, in the event of deviations occurring, all necessary measures will be taken to achieve such objectives. Lastly, and more clearly than on any other occasion, I must reiterate what I have said in all my previous Budget-related appearances: given the high degree of decentralisation of the State in Spain, it is of paramount importance that the territorial tiers of government should also commit themselves to reducing the deficit through compliance with the provisions laid down in budgetary stability legislation.

The attention I have given to budgetary policy, in step with the rationale behind this appearance, should not however obscure one particular fact. This is namely that, at present, the main instrument available to the national economic authorities to address the crisis, strengthen the chances of recovery and push through fiscal consolidation plans are supply-side and structural reform policies, geared primarily to improving employment-generation capacity, facilitating change in the weight of productive activities and increasing the economy's efficiency and productivity. The future of the Spanish economy will turn to a great extent on these policies, not just in the long run but more immediately, where the structural strengths and weaknesses of the different economies inside and outside the euro area will be highlighted.

And what has become obvious, given the present scale of public spending derived from the deterioration in employment, is that the viability of any credible budgetary consolidation strategy in the Spanish economy depends on swift and far-reaching changes to the trends currently prevailing in the labour market. Without a significant reduction in unemployment it will be very difficult to reverse the course of public spending and ensure a sustained recovery in the tax authorities' capacity to raise revenue. The downturn in employment and the rise in unemployment are the most serious problem facing the Spanish economy, and that most hampering the recovery and fiscal consolidation. Unavoidably, then, reforms to labour institutions must be promptly undertaken that draw our unemployment rate closer to that of the more developed countries, thus checking flows to unemployment and enabling workers who have lost their jobs to return as soon as possible to an active working life.

The reforms should encompass a wide range of institutions. Innovation in hiring arrangements is needed to provide for maximum job creation. We must rectify the pronounced segmentation currently characterising a labour market with a high temporary employment ratio, with most adverse consequences for job stability and for efficiency and fairness in the economy. In turn, collective bargaining needs reforming. This is so as to allow wage settlements to be tailored to a greater extent to each company and to the business cycle, but also to equip companies with the necessary flexibility to increase productivity and wages wherever possible. All these developments will help soften the impact of the crisis on employment, reallocate surplus labour towards more productive sectors and raise our economy's potential growth rate. And there are more reforms recommended by analysts: the re-directing of support policies to the unemployed, so greater importance is given to active policies such as training, improvements to the intermediation capacity of public employment services, etc.

In addition to the reform of labour institutions, there are other areas where action should not be delayed, even though the effects will be over a longer term. This is the case primarily of education, which is pivotal for ensuring a continuous increase in human capital and for reinforcing one of the main sources of improving productivity. And, of course, there is a long list of reforms outstanding to increase competition in many industries, such as services, energy, rail freight transport, etc., to which I have repeatedly referred.

Lastly, the soundness of the financial system is essential for ensuring the financial flows needed to restore economic dynamism. The Spanish financial system has weathered very well the direct and indirect effects of the international financial crisis thanks to a series of widely known factors that I shall not repeat here. However, the intensity of the adjustment the Spanish economy is undergoing in a setting of prolonged financial tension further compounds the pressure on the financial system in terms of asset impairment, increased bad debts, narrower banking margins and the gradual reduction in the buffers built up by the system. Not all institutions are equally prepared to face these factors. Accordingly, appropriate mechanisms – such as, in the current circumstances, the Fund for the Orderly Restructuring of Banks – are crucial for tackling the necessary restructuring processes, without that entailing a distortion in credit flows that may hamper the economy's path of recovery.

To conclude, the Spanish economy is at a decisive crossroads where many challenges must be addressed to prevent the situation leading to a long period of economic weakness and to be able to embark on a new growth path based on a more productive and sustainable pattern. This is not the first time in our recent history that we find ourselves in such a position. We emerged from similar situations in the past with major advances and with vigorous growth once the necessary decision-making machinery had been geared up to undertake far-reaching reforms. This time need be no different. Only through medium-term stability strategies and ambitious and well-structured reforms can we overcome these difficult circumstances, paving the way for a new phase of dynamism and job creation that will further the outstanding trajectory of the Spanish economy in recent decades.