BANCO DE ESPAÑA
Eurosistema

Madrid, 7 October 2008

Testimony of the Governor of the Banco de España, Miguel Fernández Ordóñez, to the Parliamentary Budget Committee

Miguel Fernández Ordóñez
Governor

Budgetary discussions this year are taking place at a time when the Spanish economy is deep in a process of adjustment proving much more pronounced than initially expected. The international backdrop is marked by the weakening of the US economy, sharp rises in oil and commodities prices and, above all, the scale and persistence of the turmoil on international financial markets. Given the latest events in the United States and Europe, it is no exaggeration to say that we are faced with a global financial crisis without precedent in recent times which will require an overhaul of the principles that have governed the regulation of international finances in recent decades.

The world economy is in exceptional circumstances, with a general loss of economic dynamism, surging inflationary pressures and serious financial instability problems. These are exacerbating and accentuating the adjustment of the Spanish economy which the exhaustion of the cycle had already set in train, following a long period of expansion. Moreover, this is the first occasion on which the Spanish economy has faced such a process since joining the Economic and Monetary Union, which provides undoubted buttresses but also poses considerable challenges. The economic policy debate behind the preparation and approval of the Budget is thus of crucial importance.

The far-reaching changes in the Spanish economy in recent decades have equipped it with the wherewithal to overcome this difficult stage and to subsequently resume a path of sustained growth, allowing convergence to continue. But if these factors are to operate, the authorities and all agents must face up to the current circumstances and make the required efforts, and economic policies must prevent any slippage and enable the factors conducive to the resumption of sustained growth to come into play.

Naturally, I shall focus today on the diagnosis of the situation of the Spanish economy and on its economic policy implications. But these would both be incomplete without some, albeit brief, reference to the deterioration of the international setting and to the economic outlook in the euro area which, as you know, will determine monetary policy developments.

Last year, the growth of the world economy reached 5%. The forecasts available for this year, however, place the figure below 4%, with scarcely any scope for the start of a recovery in 2009. Moreover, any recovery will be moderate, slow and subject to a degree of uncertainty fuelled, among other developments, by a rise in major inflationary pressures in most economies. In my view, there are three basic factors behind this deterioration of the global economic situation.

The first is the adverse behaviour of the US economy, weighted down by the continuing decline in its real estate sector, which is depressing household and investor confidence. Until relatively recently, the emerging economies have been considerably more dynamic, partly offsetting the greater slackness in the more industrialised countries such as the United States. However, doubts over the real ability of these economies to continue posting robust growth rates amid the virtual stagnation of the more advanced countries are ever greater.

The increase in oil and commodities prices is the second of the basic factors behind recent developments in activity and inflation at the global level, despite the relative easing since the summer. The effects of these price rises have been fully felt in the more advanced economies, while in the emerging economies the pass-through of higher energy costs is proving slower and is still far from complete.

But it is the third of these factors that will most likely influence developments in the world economy in the coming quarters. I refer here to the severe worsening of the financial crisis in United States and in much of Europe, and to the turmoil on international financial markets.

Somewhat more than a year back now, when the US subprime mortgage crisis broke, there was great uncertainty over the scope and duration of the episode then beginning. Today, there is unfortunately no doubt that we are facing a global financial crisis of enormous proportions.

Although at first the difficulties appeared to be confined to just a few investment funds and relatively minor US mortgage institutions, the overall number of banks affected has since widened considerably. We have witnessed a process, with no practical solution in sight, involving nationalisations, bankruptcies, bank interventions, the creation of new investor guarantee schemes and considerable curbs on market practices, such as those affecting the short-selling of equities.

The list of institutions affected includes most notably: the major investment banks, whose business model has succumbed to the turmoil; the US government-sponsored mortgage agencies; one of the biggest worldwide insurers; and major US credit institutions. In Europe, UK, Danish and Icelandic banks have been involved, as have more recently those from euro area countries such as Belgium, the Netherlands, Luxembourg, France and Germany. Moreover, several European governments have announced their readiness to guarantee their banks' deposits.

The foregoing developments pale into insignificance in the face of the importance of the US Treasury's decision to propose a far-reaching programme whose stated aim is to tackle globally the serious problems besetting the American financial system. The initial appropriation of $700 billion for this programme, and its dramatic presentation by the US Treasury Secretary, illustrate the scale of the problem. As you are aware, the plan was finally approved following heated debate in the House of Representatives and in the Senate.

Clearly, beyond its effects on specific banks, this unprecedented crisis is profoundly shifting some of the key coordinates that have framed global financial developments in recent decades. An economy such as Spain's, which has been financing a substantial proportion of its expenditure abroad, can hardly isolate itself from the consequences of such deep-seated changes.

International financial markets have moved from a situation of widespread risk undervaluation to one in which extraordinary caution is exercised in their evaluation. Past experience has clearly shown the tendency of markets to overreact. It is even possible that certain recent developments reflect, at least partly, an excessive reaction. But it is unreasonable to expect that, once the situation has returned to normal, international financing conditions will simply be as they were prior to the summer of 2007, which nobody today hesitates to qualify as excessively lax.

Likewise, few question the fact that the expansion of the balance sheets of a large number of major financial institutions exceeded limits which should not have been overstepped. The current deleveraging process may initially reflect the correction of some of the excesses committed. But taking a broader view, it also reveals a more fundamental movement towards a general reduction in the debt levels of financial intermediaries and the containment of credit flows, the effects of which must likewise be felt by the ultimate borrowers, namely households and firms.

Finally, I should point out that the magnitude of the imbalances generated and the scale of intervention designed have prompted a necessary pause for reflection on the role the economic authorities should play in developing and supervising financial markets.

For the moment, however, I shall simply reiterate that one of the aspects highlighted by the current financial crisis is how important it is for central banks to have the appropriate instruments with which to manage their liquidity provision policies with sufficient flexibility. And all the more so in the presence of turmoil which, as at present, is profoundly altering the operation of the channels through which liquid resources are normally re-distributed among the various banks that apply for them. In this respect, it is widely acknowledged that the Eurosystem's monetary policy operational framework is allowing euro area banks' liquidity requirements to be met, thereby preventing the emergence of additional pressures that might exacerbate the situation on financial markets.

In any event, returning to the most important macroeconomic developments that will influence the performance of the Spanish economy, it is clear that financial conditions in the euro area, as in the rest of the world, have tightened notably. Such tightening has compounded the adverse effects of the oil and commodities shocks on agents' real incomes and output capacity. The latest data, for the second quarter of the current year, show how the growth rate in the euro area has weakened to 1.4%, standing below potential. The latest ECB projections pointed to increases of between 1.1% and 1.7% this year, and between 0.6% and 1.8% in 2009, subject to considerable uncertainty and to downside risks that have increased in recent weeks.

In addition, while growth was slowing, inflationary pressures were heightening and inflation expectations were being revised upwards, which has raised the risk that they may become unanchored. Nobody doubts that an eventual loss of control of inflation, with the subsequent deterioration in price expectations, would contribute to seriously exacerbating a slide towards economic weakening in the area.

Such is the difficult setting in which the ECB Governing Council has had to take its monetary policy decisions. These decisions have been pondered bearing in mind at all times the impact of tighter financial conditions and of the change in the dynamism of demand. Thus, against a backdrop of growing uncertainty, it was decided to hold interest rates steady until last July, when the materialisation of some of the previously identified risks to price stability made a 25 bp increase necessary.

At the recent Governing Council meeting, however, we noted a weakening in activity in the area and the fact that the latest price data point to the onset of some easing. Inflationary risks have therefore diminished somewhat, though they have not disappeared, meaning that monetary policy should continue contributing to containing them. Given the seriousness of the tensions on international financial markets, we also reiterated the readiness of the Eurosystem to provide all the liquidity required for as long as should prove necessary.

Let me now turn to the Spanish economy. As I was able to explain to you here before the summer, the change in cycle in Spain had started before the episode of financial turmoil, making itself felt mainly in the real estate sector, which set in train a correction of the excesses that had built up during the long expansionary phase.

These excesses had largely arisen owing to the global environment of financial laxity and undervaluation of risk, and to monetary and financial conditions that were particularly accommodative for Spain following EMU membership. These conditions were based on interest rates that held at low levels over a very extensive period and which were conducive to rapid indebtedness by households and by firms, mainly those related to the real estate sector.

In any event, the adjustment of the real estate sector began slowly, mirroring the gradualism with which the determinants of residential investment changed. Hence, as the change in monetary policy stance that began in late 2005 progressively passed through to household and corporate borrowing costs and as the overpricing of housing became more patent, the dynamism of the sector eased off.

However, this gradual pattern was altered when the international financial crisis raised credit risk premiums across the board, blocked a most significant part of banks' wholesale funding mechanisms and spread uncertainty and mistrust, most particularly in respect of economies subject to real estate adjustments. Against this background, the demand for housing fell off drastically, when the production of houses was still at a very high volume. House prices, after several years of increasingly more moderate rises, began to post small declines in some market indicators as from the second quarter of this year, while housing starts fell by almost half. This abrupt change in scenario, together with the tightening of financing conditions, which I shall address in greater detail later, meant that real estate companies had to restructure, with some of them even going bankrupt. This series of factors compounded the correction of the residential sector with adverse consequences for employment, which is acting as the main channel through which the adjustment of the sector is spreading to the rest of the economy.

Household consumption is rapidly reflecting the deterioration in confidence, against a backdrop of considerable financial tensions, and the abrupt turnaround in the employment situation. As a result, a certain rise in the saving rate consistent with the current scenario of greater uncertainty and financing difficulties might be taking place. I should stress that this far-reaching slowdown in private consumption is the factor that is most contributing to the loss of dynamism in the economy. Business investment also slowed rapidly, in line with the changing financial conditions, the profile of domestic demand and the deterioration in business confidence. Nonetheless, exports are sustaining a relatively high growth rate, despite worsening world trade so far this year, and they are providing some support to investment in equipment.

This sound performance of foreign sales, along with the marked cut in the rate of increase of imports, has seen the external sector make a positive contribution to GDP growth for the first time since 2001, partly cushioning the slowdown in national demand. Net external demand is therefore providing a buffer of support against the widespread weakening trend.

On the supply side, the fact that the sharp adjustment in employment is taking place just when labour costs are posting high increases is of particular relevance. This is because collective bargaining is taking on board the deterioration in inflation expectations and because the activation of indexation clauses is passing through last year's inflation deviation to wages. Unfortunately, there is a risk that this will occur again in 2009, potentially causing second-round effects in an economic situation in which the behaviour of employment is very important, as I stated, for regulating the cyclical downturn in the economy. Furthermore, this increase in wages has not been accompanied by productivity gains on a similar scale. Therefore, the increases in unit labour costs continue to be higher than those of our trading partners. If, moreover, business margins were to continue widening as they have in the past, the difficulties for the economy of competing abroad would increase, undermining one of the potential sources of recovery.

Inflation posted a rapid increase in the first half of the year, despite the loss of momentum of activity. As in other countries, the surge in oil and food commodities prices largely explains this, although the Spanish economy's high energy dependence and low energy taxes have tended to amplify this effect. The latest figures point to the start of what should be a phase of gradual containment, though I shall return to this point later.

Among the factors that have weakened expenditure growth is the tightening of financial conditions. Given its close relation to the international financial crisis, it is appropriate to focus on the analysis of the behaviour of credit in Spain during this period.

Loans granted by resident banks to Spanish households and firms began to slow before the increase in defaults on US subprime mortgage loans unleashed the present international financial crisis. The gradual increase in financing costs, the downward revision of expectations of future income and rises in wealth, and the very levels of debt attained had already acted before the summer of 2007 to lower the growth rate of debt towards a more sustainable pace.

Naturally, greater caution in risk assessment and the sharp reduction in international financing flows that the international financial crisis has entailed have further dampened the supply side, likewise contributing to slowing credit.

As an overall result of both forces, the latest figures show year-on-year growth rates of financing to Spanish households and firms of around 10% and 7%, respectively. Analysed from a shorter time perspective, the expansion of credit proves somewhat more moderate, although it is not significantly removed from nominal GDP growth. As might be expected in the current situation, characterised by greater uncertainty and risk aversion, new loans are being granted under more onerous conditions than in the past, which include lower loan-to-value ratios and shorter maturities.

The trajectory followed by credit in Spain to August may be said to be behaving in a manner consistent with the process of adjustment the Spanish economy is undergoing and with the prevailing global conditions, which entail higher financial costs, heightened risk aversion and serious difficulties in obtaining funds on international financial markets.

From the standpoint of financial stability, Spanish banks have demonstrated greater resilience than their counterparts in many other countries. But as I have previously stated, there is no room for complacency here, since the challenges ahead are considerable. A crisis such as that currently rocking worldwide financial markets can hardly be neutral for those who depend on such markets to a relatively greater extent. And nor can the fact that a sizeable portion of the Spanish financial system's financing flows is tied in one way or another to the real estate sector be ignored either.

However, for numerous reasons, including most notably the quality of our regulation and supervision, Spanish banks have not been involved either in the generation, marketing or acquisition of the toxic financial products that are inflicting such harm on the international financial system. Their levels of efficiency, profitability and solvency have placed them, moreover, in a position of relative strength to withstand this crisis.

Accordingly, and in the light of the events currently unfolding daily in the international financial system, I wish to make a call in my capacity as governor of the Banco de España for calm, and to reiterate my confidence in the Spanish financial system, which is well managed, regulated and supervised. I can assure you that at present there is no threat to Spanish depositors' savings.

All these considerations on the international financial crisis add great uncertainty to the outlook for growth in the Spanish economy. The information available points to practically zero or even negative quarter-on-quarter rates of change in the second half of the year, and to the extension of the adjustment into 2009, with rates of increase in output that are more difficult to gauge but which will probably also be weak. The ongoing correction of residential investment may be expected to intensify, since the figures for work under way will show next year that housing starts have ground to a halt. It is likewise foreseeable that the slowdown in consumption will continue, due above all to the weakness of employment, and that business investment will mirror the decline in activity. Accordingly, the contribution of domestic demand to GDP growth might turn negative, and would only be relieved by the external sector if the buoyancy of exports and, as seems likely, the slowdown in imports continue. The importance that the dynamising effect of the external sector acquires in the current circumstances highlights the relevance of competitiveness in the future.

The foreseeable trend of inflation points to increasingly more moderate average price increases during the rest of the year, owing largely to the baseline effects of the energy and processed food price increases late last year and to the recent declines in crude oil prices, provided these are sustained. This trajectory should extend over the coming year, further supported by the sluggishness of demand. However, to attain fuller and more sustainable convergence with the euro area, the upside risks stemming from the indirect and second-round effects of cost and price increases this year must be prevented from materialising.

The macroeconomic basis on which the government has drawn up the State Budget for 2009 includes, in its main outline, the trajectory of the macroeconomic adjustment I referred to earlier. But it is subject to major downside risks, especially as regards the course of domestic demand and, in particular, of residential investment. It should further be borne in mind that the global economic situation and the impact of the international financial turmoil tend to heighten these risks.

The design of the Budget should take into consideration the pronounced change in the economy’s cyclical situation, and bear in mind the speed at which public finances are being affected. In previous public appearances I have warned that the sound fiscal results of the previous years had a component very closely linked to the expansion of the real estate sector, which would tend to disappear in lower growth phases. Unfortunately, the loss of momentum of tax revenue is proving acute. And combined with the significant revenue-related impact of the expansionary measures taken this year, that means that the end-year figures for public finances in 2008 will be worse than projected only a few months ago, and that the general government balance at the end of the year will be in deficit.

The weakness of activity in 2009 will give rise to a deficit-widening dynamic which, given the uncertainty facing us, will mean that that the deficit may be greater than forecast in the draft Budget. I must reiterate here the call for prudence in fiscal policy management, whereby budgetary policy should focus on allowing the automatic stabilisers to continue deploying their intended countercyclical effect, while preserving the bases for maintaining a sound position in the long term. Given the uncertainty surrounding the world growth scenario, it is important that fiscal policy should retain room for manoeuvre in the face of potential situations of greater weakness. Nothing could be worse than having to face fresh turmoil when the only option possible is that of having to reduce the deficit, as we have had to do in the past and as has happened recently in other developed countries. Further, the major advantage for the Spanish economy that maintaining a comparatively low public debt/GDP ratio entails should be preserved.

Watchfulness will also be needed to prevent current expenditure overruns that reduce the leeway available to undertake public investment programmes and fulfil other productive expenditure commitments made in the Budget. We should not forget that when public overspending occurs, the subsequent adjustment usually falls on productive spending and, most particularly, on public investment, with adverse consequences for long-term growth potential. In the current circumstances, moreover, having some scope to carry out the infrastructure investment plans under way is crucial for smoothing the adjustment in the construction sector.

The State Budget should, in my view, comply with these premises. But the regional and local governments also have a major role to play in this task, since they account for a most significant portion of public spending - and, in particular, of public investment – and are facing a phase of rapid decline in their revenue-raising capacity.

Elsewhere, a worrying aspect of the scenario I have described is the speed and intensity of the response by employment, which is amplifying the effect of the correction of the housing sector on the rest of the economy. This reveals the persistence of inadequacies in the workings of factor and product markets that mean that the weight of the adjustment falls on the level of employment, hindering the necessary reallocation of productive factors across sectors.

The behaviour of wage costs and the high margins seen in certain activities tend, moreover, to make the inflationary episode more persistent, with the adverse consequences this may have for price and cost-formation habits and for the trend of the relative prices and costs that bear on the economy's competitiveness.

It is therefore very important not to lose sight of the fact that the main instrument available in the current circumstances is that of making structural reforms that enhance the economy's flexibility, liberalise certain sectors and markets, and increase competition. Despite the efforts made in recent decades, there are still numerous areas of the Spanish economy that need reforms. I do not intend to address these in detail, but I shall refer briefly to those spheres where I consider pressing action is needed. And I should stress that it is here where the potential room for manoeuvre to counter weakening growth in the euro area is to be found.

In the labour market, it is imperative to bring about a milder reduction in employment in cyclical slowdowns. In this connection, we must explore channels which provide a response by wages to changes in the economic environment, aligning them to productivity gains, and avoiding upward inertia in the face of external shocks introduced by mechanisms such as wage indexation clauses. It is also vital to hold long-term unemployment at low levels, and to do this the move from unemployment to employment status must be made easier, improving the workings of employment services and the effectiveness of active policies.

In the housing market, the regulations governing renting must be improved to make it more flexible and profitable so as to promote the acquisition of houses for investment purposes, and thus help reduce excess supply. Further, putting these houses on the rental market would make it easier to meet the population's demand for residential services.

In services activities and, in particular, in the distributive sector there is also much scope to set in place a more competitive environment and achieve sizeable gains in efficiency. I consider that the transposition of the services directive offers a unique opportunity for headway in achieving the objective of reducing our rate of inflation and increasing the economy's competitiveness and household purchasing power in a setting in which incomes have been dented by dearer oil and the slowdown in employment.

With the same objectives, improvements in the regulation of the network industries and, in particular, of the energy sector should be made to promote competition and increase energy efficiency. The same applies for port, airport and railway freight transport services, sectors which are essential for strengthening the competitiveness of Spanish industry and exporters.

To conclude, I am confident that if the Spanish economy is capable of mobilising the potential nurtured over many years of building up stability and improving the workings of markets and institutions, then it may rise to the challenges and difficulties facing it and continue to make progress in the medium term in narrowing the welfare differences with the most advanced countries.