

# Concluding remarks

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Pedro Solbes, *Second Vice-President of the Spanish Government and Minister for Economy and Finance*

GOOD AFTERNOON, GOVERNOR, MEMBERS OF THE GOVERNING council, ladies and gentlemen,

Let me first of all thank the Bank of Spain for its kind invitation to be here with you today. It is always a pleasure for our country to host the meeting of the European Central Bank Governing Council. It is a particular pleasure if it is coupled with a symposium with such qualified attendance.

You have been discussing very interesting topics throughout the day. My comments today in closing this conference will deal with some of them, specifically those of the last two sessions: financial stability and macroprudential issues, and global imbalances. In both cases, I will discuss them briefly while trying to convey how these issues are viewed from outside the realm of central banking.

I will purposefully leave out the session on settlement systems, which as you know is a, shall we say, difficult topic for non-central bankers.

Macroprudential concerns have been high on the agenda of central banks and other supervising entities in the last few years. The interest of supervisors has gradually shifted from what intrinsic features make a bank vulnerable, to which macroeconomic traits might portend a general economic correction that could render some apparently sound banks vulnerable. This represents a remarkable change of emphasis from a decade or so ago. Let me offer two reasons which might partly explain this trend:

First, the supervision of banks at the micro level is now on a very sound footing. This is due to several factors: the microeconomic literature on bank solvency and bank runs has come a long way in the past decade and a half, while supervisors have displayed a high degree of competence in the execution of their tasks; in our country, we have the outstanding example of this in the Bank of Spain. Supervision as such has improved markedly, but equally important in disciplining bank behaviour have been the strict enforcement of rules governing the ad-

equacy of bank management teams and the prudent but vigorous exercise of moral suasion by supervisors. The progress in constraining individual bank behaviour to forestall future problems has been remarkable, even if some important challenges remain.

Second, behavioural finance has shown us the importance of the herd instinct in all financial issues. There are reasons to believe this instinct to be somewhat less prevalent in banking than in financial markets, for a variety of reasons; but of course banks are more fragile than investment vehicles, for reasons well known, so that inadequate behaviour among banks is much more worrying to all of us, not least to Governments who guarantee deposits. Therefore, inasmuch as excessively expansive macro developments could be due to herd-like imprudent lending by banks, macroprudential concerns and responses would be warranted.

In any case, we have to exercise care so as not to apply these concerns indiscriminately. A rapid buildup of debt may sometimes be a sign of rational adaptation to a new economic environment; increases in asset prices could be reflecting improved economic circumstances and not collectively irrational behaviour on the part of investors.

The creation of the euro area is certainly a case in point. For countries such as Spain, membership of the Monetary Union has entailed a dramatic break with our past of macroeconomic instability and high interest rates. This accounts for higher asset prices, since the existing capital stock becomes more productive, and hence more valuable, by virtue of this new macroeconomic environment; and lower interest rates lead to those higher future returns having more present value. The increase in investment and debt is also to be expected, with the inevitable lags, due among other factors to adjustment costs associated with changes in the physical capital stock.

We can debate the timing and size of these effects, and both issues are very much part of the economic discussion in our country, but the effects undoubtedly exist and are significant. We should therefore be wary of simplistic analyses which deem increases in asset prices and debt accumulation to be imbalances by definition, therefore requiring automatic corrections from the economic policy side.

If the creation of a monetary union seems too unique to be a general qualification to the macroprudential baseline case, there are other examples: in fact, any positive exogenous shock to the supply side of the economy would lead to an increase in the prices of assets and probably induce a faster rate of debt accumulation, as economic agents adjust their intertemporal consumption desires. This would be fully rational and would not require any economic policy response. Of course, one could qualify the applicability of this argument by pointing out that a main source of such shocks is structural reform, and that the euro area is not seeing much of it.

The rationality of the asset price escalation-buildup of debt is a very important part of the macroprudential discussion, and has justifiably been one of its main focal points. But another key element is often lost in this debate: the role of am-

plifying factors. I am thinking in particular of two: budgetary behaviour on the Government side, and labour market issues.

The fiscal response on the Government side is important, inasmuch as it can temper the expansive impulses that private demand is experiencing. If fiscal restraint from the public side compensates the higher propensity to spend on the private side, aggregate saving can remain stable, offering an important anchor for the economy; among other things, this would normally ensure that private investment accounts for most demand growth, so that we would have *prima facie* reason to believe that the new capital stock will generate enough returns to service the incurred debt.

Meanwhile, developments in the labour market also matter. Depending on labour market institutions, the expansion of demand attendant upon higher asset prices might lead to excessive wage growth and therefore create greater inflationary tensions. This would mean that the push from the demand side would end up dissipating in inflation, while investment would be deterred by adverse wage developments. As a result, the society's productive capacity, and hence its ability to service debt, would not increase at the same rate as its debt and problems would ensue, first of a macroeconomic nature and then, possibly, bank solvency problems. Conversely, smoothly-functioning labour markets would properly process labour demand pressures, turning them mainly into employment gains.

Of course, the budgetary behaviour on the Government side and the evolution of the labour market are factors that would only be adding to pressures arising elsewhere, in the credit market; they might thus be thought of as secondary. But their role may actually be key in two ways: they may precipitate the correction of asset prices and the ensuing weakening of the economy, giving policymakers less time to react; and, more importantly, they may generate macroeconomic problems even if the initial asset price increase was perfectly rational. Indeed, the economic difficulties of some eurozone countries since 1999 may be attributable to the inadequate response to the financial effervescence induced by monetary union, rather than to the inadequacy of such financial developments in themselves.

Global imbalances have also been touched upon in these meetings, and they are certainly a worrying part of our economic landscape. In thinking about them, we should focus on three questions: to which extent might they have a rational economic explanation? What risks do they pose? And, what is the optimal economic policy response from an aggregate point of view?

I will deal with these questions, leaving out the political economy part of the issue, which may well be the most important one: how to convince the main incumbent countries to participate in this optimal policy response by ensuring them a reasonable participation in the benefits.

In dealing with current account surpluses, it is helpful to differentiate between those incurred by oil exporters and surpluses run by developing countries which are not relevant exporters of crude.

Current account surpluses by oil-exporting countries, and the corresponding deficits in oil-importing countries, may be rational to a large extent, in an intertemporal sense. After all, the price of oil might not remain as high as it is now in the long term, and, if it does, oil-consuming countries will end up adapting by importing less of this raw material. One way or another, oil-exporting countries are unlikely to obtain as much real oil revenue in the long term as they are enjoying now. Hence, the imbalances due to high oil prices may be considered a rational intertemporal response by oil-purchasing countries, in the form of consumption-smoothing: borrowing from nations which benefit from high crude oil prices to tide them over while the adjustment to more expensive oil takes place.

In the case of developing countries with current account surpluses, the situation is different. First, these nations are exporting capital while they still have pressing investment needs of various kinds, not least in the environmental area. One might deem this a secondary concern, given the high rates of investment that many of them are nonetheless sustaining, but there is also the issue of consumption: at present, poor developing country families are foregoing consumption on a large scale to finance much richer consumers in developed countries (as well as government deficits in some of them). Whether this makes any sense is at least debatable. There is reason to believe, furthermore, that some of these imbalances may be caused by exchange rate policy.

But, as we know, one country's surplus is another country's deficit. And it is also apparent that fiscal indiscipline in some developed countries, particularly the US, is unduly eroding its national saving rate and therefore contributing to its current account deficit.

We all know the risks that excessive current account imbalances entail. Mainly, the risk of a disorderly correction in exchange rates, with currency disruptions and damage to the world trade system. The fact that part of the imbalances can be considered logical from an economic standpoint offers some consolation, but only some; after all, oil-exporting countries are also accumulating assets vis-à-vis deficit countries. If a currency crisis arose, there is no obvious reason to believe that these assets would not be part of the selling trend just as other assets that surplus countries have accumulated in recent years.

It is therefore heartening to see that incumbent countries have finally started to take action in dealing with these imbalances, from a cooperative standpoint. More important than the specific actions that have been adopted up to now is the fact that these countries recognize that imbalances pose problems and that joint action can be beneficial to the world as a whole. After all, currency stability is a world public good, the preservation of which is in the interest of all countries.

What specific recipes should be applied to deal with our present imbalances? Classic demand-shifting policies are undoubtedly part of the answer, and constitute the backbone of the coordination efforts that are now underway. But let me also offer some qualifications.

First of all, there is always the temptation to focus all the debate on exchange rates, and that is not desirable, for several reasons. Estimating equilibrium exchange rates is a subjective task, and exchange rate policy is perceived, rightly or wrongly, as a zero-sum game by all the main agents in this discussion; therefore, it is a variable that lends itself to shallow political discussions rather than to sober economic debates. The excessive public discussion of this topic could thus encourage protectionism and serve as a distraction from serious efforts on other economic policy fronts.

Second, it is also important to realize that there are limits to what macroeconomic policy, even if perfectly coordinated, can do or should do to address global imbalances. One reason is that some of the imbalances are due to structural factors: for example, in some countries with “insufficient consumption” from a world economy point of view, population aging, an underdeveloped financial system, or the scant availability of consumer goods may be more important causes than interest rates or disposable income. A lack of investment safeguards or a limited regard for the rule of law in a country could also inhibit investment flows to it and lead to capital outflows from this country to richer ones, contrary to what standard economic theory would predict. These structural variables cannot easily be influenced by macroeconomic policy.

We should also bear in mind that adjustment policies are not symmetric in their effects. Restrictive policies are almost always successful, while expansive policies, for reasons well known, are ineffective relatively often. Therefore, recommendations to maintain contractive economic policies in some countries and expansive policies in others might, if applied, end up reducing world demand and hence world GDP. One need not fully accept the “savings glut” theory in order to have some reservations about restraining demand in the countries that are now pushing the world economy forward.

These are some of the reflections I wanted to share with you today, by way of closing this symposium. Let me add one last comment, at the risk of stating the obvious: these are very important issues. There is often the tendency to dismiss them as topics of interest only to central bankers and G-8 ministers, but they have a substantial impact on the long-term welfare of our societies. We all benefit from an economic growth which is balanced among the different regions and hence less vulnerable to corrections. Equally beneficial, as we know very well in Spain, is having a robust, high-quality banking system, resistant to shocks and efficient at channelling savings towards investment.

I hope this conference has served to advance the state of knowledge in all these questions.

Thank you all for your attendance,