

**PRESENTATION  
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Governor's address  
to the Governing Council of the  
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ADDRESS TO THE GOVERNING COUNCIL OF THE BANCO DE ESPAÑA  
ON THE PRESENTATION OF THE *ANNUAL REPORT*

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## Address to the Governing Council of the Banco de España on the presentation of the *Annual Report*

Ladies and gentlemen,

I present to you today the *Annual Report* for 2007 in a national and international economic climate far different than in previous years. The world economy, which had been exhibiting notable dynamism in recent years, has been impacted practically simultaneously by three far-reaching shocks. These affected global growth as early as the second half of last year but they will, above all, influence future developments.

Evidently, I am referring to the rise in prices of oil and other commodities and of food, to the deterioration in the US cyclical position and to the turmoil in international financial markets.

The economic history of the last century offers sufficient examples to illustrate how any of these three shocks could, on its own, have weakened the world economy and confronted the economic authorities with major dilemmas. It is no surprise, then, that the concurrence of the shocks has led to the downward revision of global growth prospects, or that old debates have been revisited about the use that should be made in this situation of the various economic policy tools available. And this against the backdrop of certain singular challenges to which the new pressures have given rise in terms of maintaining macroeconomic and financial stability.

These shocks have hit the European economy at a time of buoyant activity and heightening risks to price stability. Conversely, in our country, the economy was already beginning to move into a slowing phase, following an exceptionally long period in which GDP had been posting notably high growth rates.

In my overall description of these varied and complex matters, I shall attempt to focus in somewhat greater detail on those that are most relevant. Referring as I must to the international setting, I shall concentrate on analysing the two factors which, in my view, are the main source of uncertainty at present: the factors of financial instability and the scale of the recent surge in inflationary pressures. The figures for 2007 as a whole show a world economy that continued to exhibit the strong dynamism of previous years. Growth stood at a rate of around 5% for the fourth year running, and although this was fairly generalised across the different regions, it was the emerging economies which were once more to the fore, accounting for practically 70% of the increase in world GDP.

Nonetheless, these figures mask significant differences between the first and second halves of the year, once the international financial turbulence was triggered. Unsurprisingly, the impact of the turbulence was initially particularly marked in the United States which, as we know, was its epicentre. Indeed, the US economy had been suffering from the effects of the adjustment in its real estate market for at least a year previously. However, GDP had held at a growth rate close to potential until the first half of 2007, when the sub-prime mortgage default problems emerged. These spread to the rest of the financial system, heightening the intensity of the real estate adjustment and shifting the economy onto a strongly slowing path.

The rest of the world has not been immune either to the slowdown in the United States or to the financial turbulence originating there, although the effects so far appear to have been more marked in the industrialised economies. The notable resilience shown by the emerging economies is, in fact, proving to be one of the most singular features of this phase. This is not the occasion to enter the current debate on the reasons for this apparent decoupling. But I would

say that future developments in this connection will ultimately have a significant bearing on world growth in the coming years.

The outlook for the global economy in 2008 has been unanimously and substantially revised downwards. This revision has also been accompanied by the acknowledgement of greater-than-usual uncertainty, attributable to the build-up of various factors of risk. The behaviour of the industrialised economies and, in particular, of the US economy is currently much more uncertain than a few months back, as the debate on how the United States can exit the crisis testifies. And certainty is no greater concerning the behaviour of exchange rates and their influence on global imbalances that are still a long way off being corrected.

But the main source of uncertainty at present still lies in the possible trajectory and outcome of the serious international financial strains. I shall refer to this now from an exclusively international perspective, addressing the situation of our financial system later.

A local financial shock such as that which affected the US sub-prime mortgage market last summer does not become the large-scale and serious phenomenon it currently is unless this is as a result of other structural failings in the framework through which international financial flows are channelled.

Significantly, some of the possible weaknesses were identified some time ago by those responsible for ensuring the soundness of the system. Virtually all international financial stability reports dated before the turbulence warned of a more-than-likely general underestimation of the risks incorporated into the main financial assets, the most evident sign of which was to be found in the excessively low premiums being negotiated on markets.

The fact the macroeconomic setting was favourable, with notable growth rates and risks to price stability that were then moderate, undoubtedly contributed to generating excessive optimism in the markets and to a deaf ear being turned to the warnings made, while fomenting growth in household and corporate debt levels globally.

The progressive leverage at the international level, which subsequent events revealed to be excessive in some cases, was favoured by the emergence of new financial products and vehicles which helped credit institutions raise the resources they needed to meet the growing demand for loans. Specifically, financial innovation in the field of securitisation played a primary role in this process.

All these factors contributed to generating a climate of financial exuberance which masked the structural deficiencies building up. When the events last summer abruptly dented investor confidence, the underlying problems were suddenly exposed. In my view, there are three main fronts on which these global problems are present.

The first of these fronts is to be found on the line where financial innovation processes come up against the regulation of markets and financial intermediaries. Recent events have evidenced the insufficient adaptability of the regulatory framework in some countries to the emergence of increasingly sophisticated products and vehicles outside the consolidation scope of institutions. When financial innovation processes are underpinned precisely by the existence of regulatory arbitrage opportunities, it is a sign that regulation is ill-conceived.

Nor do some of those products that have arisen in recent times in the field of credit securitisation, which are of a complexity and – indeed – opaqueness that hampers the correct ap-



praisal of the risks assumed on acquiring them, offer real added value for investors. This is the second of the fronts to which the financial authorities of many countries and competent international agencies should pay particular attention in order to prevent situations such as the present one from recurring.

The third and final front on which I consider it will be necessary to concentrate efforts at the international level is that of cooperation among supervisors. Although there has evidently been a breeding ground conducive to the spread of the turbulence, the growing internationalisation of flows and of financial intermediaries themselves has undeniably played a key role in its rapid spread. When market players acquire a global dimension, the authorities entrusted with supervising them should do likewise. There are several possible ways in which progress towards this objective may be made. But for many reasons, I am convinced that the way offering the best guarantees at present is that of greater cooperation among national supervisors, based on a fluid exchange of relevant information.

Allow me to move on to another factor of risk to world growth and, above all, inflation which, in my opinion, merits particular attention: the ongoing rise in the price of commodities, particularly energy, and of food.

Broadly, the strong rise in the prices of these products has chiefly been associated with the forceful increase in the demand for them, especially by the emerging economies. The energy requirements of a clearly expanding industrial sector and the changes in consumption and eating patterns, generally derived from a higher level of wealth, are probably the main factors behind this buoyant demand.

But the pressures have also highlighted the current constraints on expanding supply, at least in the short term. Limited surplus production and refining capacity no doubt lies behind the surge in oil prices since early 2007. Likewise, there are also supply-side factors linked, in some cases, to particularly adverse weather conditions at the root of the acceleration in food prices. In the medium term, it is possible that the vigour of demand will stimulate the search for more efficient production processes that allow supply-side capacity to expand. But it is unlikely in the immediate future that we will see significant corrections to energy and food prices, which will no doubt remain high. We cannot even rule out the risk that recent trends will hold, with the consequent expansionary effects on aggregate inflation rates. Nor should we underestimate the possibility that the adjustment in relative prices is perceived as a permanent and not a temporary increase in inflation, which will exert an adverse impact on wage negotiations and margin formation, triggering dangerous wage/price spirals with all too well-known effects.

The upshot has been a particularly complex situation for most central banks, in which inflationary pressures have combined with a marked trend for activity to slow and substantial risks to financial stability. I shall now address the dilemmas this situation poses from the more specific perspective of the Eurosystem's monetary policy, whose decisions bear much more directly on the Spanish economy.

In 2007, GDP growth in the euro area exceeded 2.5% for the second year running, although activity showed a high degree of volatility throughout the year. In fact, the effects of the various international shocks mentioned and of the appreciation of the euro began to make themselves felt in the final quarter.

Yet both last year and in the opening months of 2008, the euro area is showing significant resilience, underpinned in the external arena by the continuing strength of the emerging econo-

mies and, internally, by the dynamism of the labour market. Over the medium term, however, there is notable uncertainty over how the European economy will perform. In recent months, private institutions and international agencies have revised their growth forecasts for the euro area downwards to rates of around 1.5% for this year and 2009. The Eurosystem has also recently released forecasts, estimating that GDP in the area might grow at around 1.8% in 2008 and at 1.5% in 2009, with predominantly downside risks.

Prices in the euro area have been influenced, inevitably, by developments in the international markets for commodities and food. Inflation has finally reached a rate of over 3%, a figure practically unprecedented since the outset of monetary union. In the coming months inflation will foreseeably remain high, beginning to decline gradually in the final stretch of the year, and continuing to do so during 2009. But even this scenario is subject to upside risks. This is particularly so because, when unemployment falls and capacity utilisation is high, there is a danger that the inflation levels recorded may give rise to second-round effects on wage, margin and price-setting. The projected slowdown in economic growth in the area might alleviate these risks, albeit only partially.

Under these conditions, the difficulties the Eurosystem has faced have been clear and not confined to the choice of the most appropriate monetary policy stance. The financial strains particularly affected European interbank markets, where there was a sudden loss of liquidity and an increase in risk premiums. As we all know, the interbank market is a linchpin of the implementation and transmission of the single monetary policy. Accordingly, the Eurosystem gave maximum priority to helping restore the proper functioning of this market as soon as possible and, in view of events elsewhere, the Eurosystem's monetary policy operational framework proved adequate.

Nonetheless, the increase in money market risk premiums, the rise in corporate bond spreads, stricter loan supply conditions – as revealed by the results of the Bank Lending Survey – and the appreciation of the euro all entailed, for the same level of official interest rates, a tightening of financing conditions in the area. In any event, the ECB Governing Council continues to scrutinise developments and events, and it remains firmly resolved to act to pre-empt risks to price stability.

That is, in short, the international background to the analysis of the Spanish economy, to which I shall devote the rest of my address. The Spanish economy has entered a phase of deceleration and adjustment which is essentially due to the combination of two factors: on one hand, the maturation of the long expansionary cycle which has lasted more than a decade; and on the other, the shocks that have affected the world economy and, especially, international financial markets.

The growth phase that began in the mid-1990s entailed the creation of almost six million jobs, and gave rise to annual average GDP growth of 3.5% and considerable headway in convergence. In this period Spain has reaped the benefits of setting in place a regime of macroeconomic stability, of seeing through a fiscal consolidation drive and of undertaking structural changes. Throughout this phase, dynamism was fuelled essentially by the strong momentum of domestic spending, with a sharp increase in residential investment, although companies' efforts to extend their productive capacity and bolster their international expansion were also notable. This continuous demand impulse progressively gave rise to the emergence of certain imbalances, which gradually lessened the expansionary capacity of spending, requiring it to be brought onto a more sustainable path. Indeed, in the wake of the Eurosystem's change in monetary policy stance in December 2005, domestic demand had already begun to slow in

2006. In the first half of 2007, this process stepped up as a result of the effects of the gradual normalisation of monetary conditions and, above all, of the start of the correction in the real estate sector. The intensity and long duration of this sector's expansion had taken the number of houses under construction and increases in house prices to levels that made some form of adjustment inevitable and necessary.

It is with the start of the easing and restructuring of the still-high growth in the Spanish economy that the impact of the worsening international climate and of the financial turbulence that arose last summer must be situated. Despite the limited nature of the direct impact on Spanish banks, the turbulence has undoubtedly impacted our economy by prompting an increase in financial costs, due especially to the tightening of interbank rates, and by inducing banks to tighten their credit standards. However, the channel that has probably been most important has been that of the deterioration in economic agents' confidence, as a result of the increase in global financial instability and in uncertainty at a time when agents had already initiated a correction of their spending patterns.

If we focus on the Spanish economy's results for 2007, we see that, on average, it was still highly buoyant, with GDP growth of 3.8%, an annual rate that was barely 0.1 pp lower than in the previous year. In the light of my previous remarks, these annual data clearly mask a downward path during the course of the year. As compared with a GDP growth rate of around 4% in the first half of 2007, activity slowed to 3.5% in the final quarter. In 2008 this pattern of weaker output has become more obvious, with a GDP growth rate of 2.7% in the first quarter, which shows that the intensity of the adjustment is proving to be more pronounced than initially expected.

Apart from the slowdown in private consumption, the deceleration of residential investment and the adjustment in the real estate sector are having a particular impact on the rest of the economy. This sector is labour-intensive and has spillover effects on other productive branches, given its demand for large amounts of industrial goods and services. This is an aspect that highlights the enormous importance of the economy's degree of flexibility, to enable the effects of real estate adjustment to be mitigated to the greatest extent possible, since it facilitates the reallocation of resources to other activities capable of taking over from construction and helps avoid amplification of the adjustment through an excessive fall in employment.

On the other hand, one of the most positive aspects of Spanish economic developments in 2007 was the dynamism of productive investment, which grew at even higher rates than in the preceding year, at over 10% in the case of equipment investment. This strength of capital investment, which began to pick up in 2005, is an essential ingredient in the recomposition of demand growth and is conducive to the expansion of potential output, since it lays the foundations for future increases in productivity. The sound corporate situation, reflected in high rates of profitability, and the strength still displayed by domestic demand and international markets in 2007, were responsible for the need to expand the Spanish economy's productive capacity. Admittedly, this component is sensitive to cyclical conditions. In fact, its rate of expansion moderated in the second half of 2007 and in the first few months of 2008, but it is still the most dynamic component of demand.

As usual in cyclical downswings, net external demand cushioned the impact of the lower growth of domestic demand on output. In fact, in the case of Spain, the moderation of domestic demand in 2007 was offset by the improvement in the contribution of external demand to GDP. The lower growth of imports explains much of this effect, but the favourable behaviour of Spanish exports should also be noted, as they grew at a significant rate, of over 5%, despite the strong appreciation of the euro.



In the context of this pattern of adjustment, especially visible in the evolution of domestic demand and in the higher financing costs, household borrowing, which had already begun to ease the previous year, continued to decelerate, as did corporate borrowing, which had begun to moderate somewhat earlier. This slowdown was also a consequence of the greater caution exercised by banks when granting loans since, although their ability to finance new investments was not significantly reduced as a result of the turmoil on international financial markets, they did review their risk parameters for lending transactions. At the end of 2007, private sector financing was still growing in year-on-year terms at higher rates than nominal economic growth, but the rates in terms of the shortest periods were already closer to nominal GDP growth, a trend that has tended to be confirmed by the 2008 Q1 data and which must eventually result in a reduction in private sector debt ratios.

A key ingredient for explaining recent developments in the Spanish economy and analysing its outlook is the considerable rise in inflation since last summer. Indeed, it has been unfortunate that the impact of the turmoil on international financial markets has been compounded by strong upward pressures on international commodity markets, which have given rise to a substantial increase in the price of oil and of many foodstuffs. Spanish Inflation, as measured by the 12-month rate of change in the CPI, which had stood at 2.2% in August 2007, rose rapidly to 4.2% at the end of the year, and to 4.6% in May 2008.

The intensification of inflationary pressures at this point in the cycle is particularly unfavourable. Inflation rates of more than 4%, like those reported in recent months, entail a sharp reduction in the purchasing power of a large portion of the population, discourage current consumption and have a negative effect on agents' confidence, by increasing the uncertainty over future real income, which also dampens spending plans.

Admittedly, the bulk of the rise in inflation stems from external factors. The prices of energy and processed food are those that have risen most in recent months, especially as a result of the increase in commodity prices on international markets, while the growth rate of services prices has generally held steady and that of non-energy industrial goods has even fallen. The fact that the inflation differential vis-à-vis the euro area has widened in this period is partly attributable to the fact that some of the products displaying the sharpest price rises, such as fuel and certain foods (in particular, bread and milk), have a large weight in the basket of consumer goods in Spain.

Nonetheless, we should not consider these inflation developments to be inevitable and beyond the authorities' sphere of influence. The fact that Spain's price differential vis-à-vis the euro area has been persistently around one percentage point is something that has long needed correcting. This is particularly pressing now that the economy is embarking upon the necessary adjustment of the imbalances that built up during the upswing. If we examine the components of the CPI, services prices (which rose by around 4% in 2007) are probably the main obstacle preventing the Spanish inflation rate from converging with the European average, although recently food prices have also been more inflationary than in other European countries.

As is well known, in Spain increases in inflation tend to be passed through to labour costs as a result of indexation clauses. While in a context of economic boom such a feature can be accommodated without great difficulty, in the context of slowing demand it may prove more harmful. It seems unreasonable, when the increase in inflation stems from an increase in the import prices of various commodities, that the existing indexation mechanisms should attempt to avoid the inevitable loss of real income that these price rises entail. Even more importantly,

however, these clauses reduce the incentive to create employment. This means that employment, in a context of deceleration, is the variable through which fundamental adjustment is channelled and may in turn amplify this adjustment.

In recent years, unit labour costs in Spain have grown at a higher rate than in the euro area, owing to larger wage increases and lower productivity gains. A proportion of wage growth should be offset by an improvement in productivity, but this has grown at very low rates over the past decade, partly as a result of the pattern of growth. Since productivity cannot be expected to recover significantly in the short term, the drive for wage and profit margin moderation is essential to preserve the competitiveness of Spanish output and to limit the extent of the current downswing.

In a situation like the current one, in which our main export customer countries are also experiencing a downswing, the behaviour of competitiveness is a crucial element in ensuring that the contribution of the external sector counters the loss of momentum in domestic demand and facilitates the return to a path of sustainable growth in the medium term.

Based on all these ingredients, the outlook for the Spanish economy, over the most immediate horizon, is for a stage of adjustment with below-potential growth. There are, however, some mitigating factors in this scenario, which will help to cushion the fall in activity in the short term and to pave the way for a sustainable recovery in the medium term. Although the population will foreseeably grow in future at lower rates, these will remain relatively high, ensuring a dynamic supply of labour and also support for household creation and for the level of demand in the economy, through both its consumer and housing components. Also, despite the persistence of certain rigidities in the Spanish economy, we are facing the downturn with a more flexible productive, institutional and market structure than existed, for example, in the early 1990s, which means that the economy can reasonably be expected to be capable of absorbing the imbalances and shocks recorded recently. That said, Spain's membership of the euro area, by limiting the use of certain economic policy instruments, makes it essential to boost flexibility further in order to smooth the costs of macroeconomic adjustment.

Budgetary policy, meanwhile, represents a notable mitigating factor in this phase of the cycle since, as I will explain later, the budget surplus achieved means that the automatic stabilisers can be allowed to operate to their full extent. Finally, the soundness of the Spanish financial system, as I have already mentioned, is an asset of prime importance to cushion the impact that international financial instability may have on the financial conditions of households and corporations.

Obviously, the outlook I have described is not risk-free. Some risks are beyond our control, such as those arising from a sharper deterioration in the international environment, whether as a result of a more pronounced deceleration in the US economy or of greater contagion in emerging countries, which have so far barely been affected by the turbulence. The emergence of new pressures in the markets for oil and for raw materials in general may also lead to a deterioration in world growth forecasts. In the case of Spain, how strains on international capital markets develop is crucial, given our dependence on foreign saving. Slow or inadequate progress in resolving these strains may increase the cost and hinder the financing of activity in Spain and ultimately interfere with the path of adjustment, amplifying the contractionary tendencies.

In a situation such as that I have described, with considerable challenges for the Spanish economy, it is the task of economic policy to ensure that the mitigating factors mentioned are

able to operate fully and to reduce the likelihood of the risks referred to materialising, so that the impact of macroeconomic adjustment on employment and activity is limited. Moreover, if the direction of economic policy is properly set in the present circumstances, when the cyclical downturn has ended the Spanish economy may be better placed to resume a path of high growth, in line with its potential.

In any case, the intensity of the adjustment and the time needed for the economy to return to its long-term growth path will depend not only on the extent of the external shocks, but also on the efforts made by government (in particular the regional governments, given the wide-ranging powers they have acquired in recent years) and by all social agents, each within their own sphere of activity.

The main message of the *Annual Report* I am presenting is this: at a time like the present, when we are faced with a period of adjustment in an environment of financial instability, deteriorating expectations and greater uncertainty, and when the behaviour of employment will play a decisive role, economic policies must continue to be firmly based upon the guiding principles that have oriented the authorities in recent years. Accordingly, we must continue striving for macroeconomic stability and adopt further measures to improve the degree of competition, the mobility of factors of production and the flexibility of cost and price-setting mechanisms. And we must reject approaches that are too short-term oriented or that may delay the necessary adjustment or even be counter-productive.

On these premises, the leeway for applying expansionary demand policies is certainly limited. However, as is well known, the main objective of monetary policy is to ensure price stability in the euro area over the medium term, which has led the Eurosystem to keep official interest rates unchanged since June last year. This decision, along with the increase in risk premiums that has accompanied the financial turbulence, has entailed a tightening of monetary and financial conditions in line with the need to contain inflationary pressures in the Spanish economy, although this is naturally less favourable for spending.

Fiscal policy, by contrast, has some margin available to counter the cyclical deceleration, given the relatively favourable starting position of public finances, as shown by the figures that summarise their behaviour in 2007. General government recorded a surplus equivalent to 2.2% of GDP and the public debt ratio stood at 36.2% of GDP. In an adjustment phase like the one we are currently in, when starting from a sound situation, it makes complete sense to give full rein to the automatic stabilisers, allowing them to play the countercyclical role for which they have been designed and, in short, to act as an important mitigating factor. Being in a position to use these mechanisms is, in fact, a distinguishing feature that places the Spanish economy in a better position to face a slowdown than in the past.

That said, discretionary public spending increases and tax reductions that may involve a permanent deterioration in public finances should be avoided. Firstly, because the sound fiscal results of recent years have a cyclical component that is difficult to estimate, but which may be large, especially if the strong positive impact of the buoyancy of the real-estate sector over the past decade on tax revenues is taken into account. This component will tend to disappear during a period of lower growth. In fact, weakness in tax revenues has already been observed in recent months, in particular in relation to those taxes that depend most on developments in the property market.

Furthermore, discretionary measures may exhaust the room for manoeuvre that might be needed if the risks of a prolongation of the financial turbulence and of a deeper downturn in

the world economy materialise. Thus, the measures adopted should be selective and, in all cases, accompanied by efforts to contain other budgetary headings where cost reductions are possible. Special mention should be made here of the regional government spending rationalisation that is required in this new stage, especially given the notable slowdown observed in receipts from the taxes transferred to these governments, which can be expected to continue over the next few months.

All these considerations lead me, in short, to reiterate the importance that should be accorded to budgetary stability in the design of economic policy in the current circumstances. And, along with maintaining budgetary stability, the other crucial task is to improve factor and product market flexibility and efficiency, which will be pivotal in smoothing the necessary transfer of resources from the sectors undergoing adjustment to those that can take over.

Given that the behaviour of employment will play a determining role both in the scale and duration of the adjustment and in setting in motion the recovery, the efficient working of the labour market is particularly important. Measures should be adopted to prevent the burden of adjustment falling predominantly on labour, because this would have a negative multiplier effect on demand and activity through disposable income and future income expectations, and to promote labour mobility across firms and sectors.

The *Annual Report* explains how, following the changes in recent years, the labour market is now better placed to withstand the cyclical slowdown than in the past. Here, however, I wish to underline the tasks to be addressed. In particular, current temporary hiring and collective bargaining arrangements still suffer from rigidities impeding an appropriate response in terms of wage moderation, and they tend to route most of the adjustment through temporary employment, where the scope for flexibility is greatest.

Indeed, the data on the behaviour of the labour market in late 2007 and early 2008 point to a rapid loss of dynamism in employment, located in certain sectors and highly concentrated in temporary employment, and to a rise in labour costs that may adversely impact firms' hiring decisions and inflation, at a time of deterioration in the latter.

It is therefore a priority to find ways to return to the wage moderation which, with the support of the social partners, has delivered such good results in terms of job creation in the last few years. In particular, the current indexation systems should be changed as they tend to prolong the impact of bouts of inflation. This would help to prevent a temporary rise in inflation from generating a lasting deviation from the pattern of wage moderation. It would also be advisable to change the collective bargaining framework to make it easier to adapt wages to the productivity and economic conditions of sectors and firms. Also, hiring arrangements would have to be reformed to stimulate stable job creation and raise incentives to actively seek employment, without sectoral or geographical changes posing a serious obstacle to job reallocation.

In any event, the measures taken in the labour market have to be viewed as part of a set of more general actions to flexibilise and liberalise the goods and services markets and, in particular, to heighten competition and remove obstacles to the business start-ups needed to generate new activity in sectors in expansion.

The advance of liberalisation will stimulate new and profitable business niches that will generate employment, particularly in the services sector where there is a lot of potential for improvement in efficiency and productivity, as shown by recent international experience. It is thus essential to

transpose rapidly and ambitiously the Services Directive and to remove constraints on retail trade, given the crucial role played by distribution channels in productivity and price formation.

Improvements in the functioning of network industries also have considerable multiplier effects on economic growth and well-being, so regulation in this area needs to promote competition. Here I wish to mention in particular the energy sector, where the events of recent months in the international oil markets and the environmental challenges in the medium term make it recommendable to advance rapidly in extending competition to all lines of business. This, by triggering innovative processes and improving efficiency, will help to meet the environmental commitments made. It is also of primary importance to bring competition to port and rail freight services in order to strengthen the competitiveness of the industrial and export sectors.

The Spanish economy needs, in addition, a rental housing market that is sufficiently deep to meet the demand for residential services, to complement the owner-occupied housing market and to make it easier for workers to move to other regions. The reform of some of the constraints on rental market development has become even more pressing at present because it would reduce the size of the adjustment in the property sector, making for smoother re-absorption of excess supply and providing accessible solutions to the demand for accommodation. If legal certainty in the supply of rental housing were improved and restrictions on contract length were removed, it would provide much-needed flexibility during this adjustment.

Lastly, I wish to draw your attention to the importance of ensuring that the measures being implemented are all conceived with the common aim of increasing growth in the long term. In this respect, the expansion of physical, technological and human capital (through improved training and education) and boosts to innovation are indispensable.

Allow me to devote the last part of my address to looking at the situation of our banking system. During the long boom period enjoyed by the Spanish economy, the Spanish banking system was strengthened through the expansion and consolidation of its business, the accumulation of own funds and accounting provisions, investment in technology, improvements in efficiency and progress in risk management and control.

Therefore, when the financial market turmoil began in summer 2007, banks were reasonably well prepared to face the situation. I will highlight four factors which enabled the system to avoid being directly affected by this shock.

First, the core activity of Spanish banks is traditional financial intermediation, which consists of taking deposits and extending loans to households and firms, so their main source of funding is recurring, stable and based on the opening of offices in Spanish territory. Spain's more international banks, with a presence in other countries through subsidiaries, are also characterised by this business model. This produces a recurring flow of income that has considerable inertia and is particularly welcome in difficult times.

Second, the process of securitisation, which has been intense in recent years, particularly if the issuance of mortgage covered bonds is included, has been characterised in the case of Spanish banks by its simplicity. The banking system has not developed products that are especially complex or difficult to value and the securitisations have been carried out through relatively simple and transparent instruments based mainly on mortgages, without resorting to complex instruments like CDOs.



Banks have segregated a pool of assets and financed them with debt securities of the highest quality by hierarchising the SPE's liabilities and concentrating the credit risk in a capital tranche that has usually been kept on the balance sheet. The debt securities were placed directly with institutional investors, and no vehicles were used to transform long-term instruments into very-short-term bonds. Given that the banks were involved in managing the investments and shared in the risks, the facilities were managed professionally and subjected to the accounting, solvency and internal control rules governing all banking activity. In other words, Spain did not see anything similar to the originate-to-distribute model and the absence of ad hoc vehicles prevented contagion and the spread of problems.

Finally, the management of credit institutions, supported by strict accounting and solvency regulation and by supervision alert to risks, has enabled substantial provisions to be built up to cover loan losses not specifically identified in boom times, but which materialise when the business cycle changes. In general, the assets of Spanish institutions are valued with a degree of prudence that lends credibility to the sector's high levels of solvency.

While this bout of financial turmoil did not cause direct losses, the resulting blockage of the money and corporate bond markets in the euro area has had a major impact on banks.

The sharp growth and resulting expansion of demand for credit in the last ten years meant that considerable recourse was had to the wholesale corporate bond markets, mainly through the placement of asset-backed bonds and mortgage covered bonds with an average term of approximately four years. When the markets abruptly closed, and although banks had reasonable liquidity and their funding was diversified in terms of maturity and market segments, the collapse of the issues caused an intense shock.

In this difficult setting, banks adjusted their various lines of business. On one hand, they perceived a lower demand for credit as a result of the rapid slowdown of the economy. On the other, they adapted their sources of financing, competing to attract traditional deposits and, up to the end of last year, receiving funds from the Eurosystem.

That said, it should be pointed out that previously the liquidity received by banks represented a much lower proportion than Spain's relative weight in the euro area and that now the share has risen to a level equal to the Banco de España's weighting in the ECB capital key.

The primary market for bank bonds and mortgage covered bonds began to function again in April 2008, but securitisation placements with institutional investors continue to be blocked. Spanish banks have managed to place on the medium-term market (mortgage covered bonds, senior bonds and convertible bonds) a volume of around €20 billion in a very short time. As expected, the maturities are very short (two or three years), the price conditions are very severe (because credit and liquidity risk premiums have risen) and the volumes are smaller. Nevertheless, the main thing is that the widespread blockage has been overcome and corporate debt markets are beginning to express their preferences by quoting prices and not limiting amounts indiscriminately. In this environment, banks should increase their presence in the market so that the expansion of their assets is responsive to the situation of the international markets.

It is unlikely that the conditions prevailing in the financial system over the last fourteen years will be repeated. The long expansionary period of the Spanish economy has given way to an adjustment, the fall in the vigorous growth of residential construction has dented lending for housing development, construction and purchase, and the virtually unlimited availability of funds on the international euro markets with extraordinarily low credit and illiquidity risk premiums will not return.

Banks will have to accustom themselves first, to a notable decline in their business growth rates, which will be around Spain's GDP; next, to the exhaustion of the process of liability re-intermediation by re-absorption of pension and investment funds; and further, to wider interest rate spreads on their liabilities placed on institutional markets. This makes it all the more important for banks to balance and diversify the items and maturities reflected in their balance sheets and to look after secondary sources of liquidity.

The wider range of financing sources, achieved through ongoing promotional offers and the marketing of products on the international euro markets, the search for new business niches, especially by institutions specialised in the financing of residential investment, and the rationalisation of their cost structures and of their branch networks are pressing tasks for banks.

The economic slowdown will not allow banks to transfer mechanically to customers their higher financing costs and this will put pressure on margins and profits at a time when doubtful assets ratios are set to rise. Against this tighter backdrop, in which the competition in the domestic banking market is intensifying, it will not be possible to pass through to borrowers the cost of possible inefficiencies and the only solution will be to manage costs more strictly.

Before concluding I should like to broach the subject of banking supervision. Spain's model of continuous inspection in close contact with banks has worked reasonably well and has meant that the surprises of the summer of 2007 have been confined to abroad. The Banco de España has increased the required disclosures on financing structures and liquidity conditions and will continue to insist on their proper management, including stress testing and contingency plans taking into account market uncertainty. And it will keep monitoring the more innovative businesses to ensure they are rigorously set in place and seek to guarantee proper control and treatment of asset securitisation and of the use of complex products.

As to accounting provisions, an increasingly firm current of opinion favours a pre-emptive approach compatible with international accounting standards and with the acceptance of the internal models of the more advanced banks. This approach is enabling banks to gradually transfer their stock of general provisions to their new specific provisions for doubtful loans, which are increasingly notable in 2008.

The coming months will be marked by Spain's implementation of the new solvency rules known as Basel II, the circular for which was approved by this Governing Council on 22 May 2008. The improvements in bank management it has brought so far are proving useful in the current financial turmoil, and the new tools will extend the capacity of the supervisory authorities to act as and when necessary.

I also wish to say that, if Parliament approves the implementation in Spain of a new financial supervisory structure based on two supervisors ("twin peaks"), the Bank will assist in this transformation taking on the task of overseeing the solvency of all financial intermediaries, including securities firms and insurance companies.

Lastly, I cannot conclude without expressing my thanks for the support I have received at all times this year from this Governing Council, the Executive Commission, the Deputy Governor, the Directors General and all the Bank's staff. Your combined efforts have, yet another year, enabled us to perform satisfactorily the tasks entrusted to this institution. I am sure that this same spirit of working together will enable us to successfully face the challenges ahead.