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Governor's Testimony before the Senate Budgetary Committee

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Ladies and gentlemen,

I appear before this Committee as part of the parliamentary discussion of the State Budget for 2010, at a time when the deep international financial and economic crisis is giving way to a recovery, albeit one that is expected to be slow and not free from uncertainty. Following the successive downward revisions to growth projections during the summer of 2007, the outlook has begun to improve in recent months. Indeed, many countries are posting positive growth rates for the third quarter of 2009.

Yet we must acknowledge that this improvement is largely the outcome of the extraordinary large-scale measures adopted globally to boost demand and support the financial system. We still do not know whether the incipient world recovery is sufficiently self-sustaining for the exceptional stimuli to begin to be withdrawn without the risk of economic activity falling again.

In the case of the Spanish economy, the situation is more complex. While there has been a similar or even lesser decline in output than in other developed countries. However, the effects in terms of employment and public finances have been sharper. Hence the role economic policies must play to consolidate the recovery is essential. We are thus at a crossroads where it is vital to make the right diagnosis and select the right economic policy tools.

As my appearance is part of the parliamentary discussion of the Budget, I shall be analysing the Spanish fiscal policy situation. Allow me, however, to refer also to other policies I consider essential to resume the path of budgetary stability and to emerge from this crisis in the best possible condition. First, though, I would like to briefly assess the international setting and the economic outlook for the euro area which, as is well known, determines monetary policy.

Projections from various international institutions (such as the IMF and, more recently, the European Commission and the OECD) suggest we will resume positive growth rates in most countries in 2010 and 2011. But they constantly stress that these estimates are shrouded in greater-than-usual uncertainty, since the take-off of productive activity needs a sound financial basis, which in turn requires that the normal functioning of intermediaries and financial markets be fully restored.

In these circumstances, one of the main difficulties governments and central banks face is to identify the right time to disengage the extraordinary measures adopted in the financial, fiscal and monetary fields. A premature withdrawal might undermine the progress made, while maintaining an expansionary policy over an excessive period might give rise to further imbalances that are difficult to reverse and have negative consequences for growth. For the time being, what is needed is to

move forward in the design of stimulus-withdrawal strategies, so these may be applied when the right time comes.

The euro area has also shown some improvement recently, with positive growth rates in some countries as early as in the second quarter. The latest figures suggest that economic activity may be expected to show positive growth rates across the area in the third quarter. That said, the upcoming recovery will be slow, meaning that quite some time will elapse before pre-crisis output levels are restored.

Public finances have worsened considerably in the euro area owing both to the operation of the automatic stabilisers, which have responded to the cyclical downturn, and to the discretionary measures adopted to boost demand and the action taken to support the financial system. The financial crisis and the decline in activity have severely affected some European credit institutions, which have come to depend largely on public-sector support and which are immersed in a process of adjustment that may have repercussions for their ability to effectively channel funds in the future.

On the inflation front, we have continued to witness year-on-year declines in consumer prices in the euro area, due above all to notably lower oil prices than a year ago. Most forecasts suggest positive inflation rates will resume in the area in the coming months, as the comparison effects with the levels reached by commodity prices twelve months back cease to apply. Yet the considerable slack in productive capacity and the sluggish recovery in demand and activity across Europe suggest that inflation rates, while positive, will hold at moderate levels in the near future, with no risk of deflation discernible for the moment.

Given the incipient pick-up in activity and the continuation of very modest levels of both actual and expected inflation, the official interest rate for the euro area, at 1% since last May, is at the appropriate level. Switching our focus to the Spanish economy, the decline in output in 2009 is not going to be sharper than in other countries, but the contrast with the growth rates of the ten previous years is more patent. The fact is, as I have explained on other occasions, the Spanish recession shares features with other countries, but has its own hallmarks, such as the real estate adjustment and the behaviour of the labour market. The powerful external contractionary forces generated by the international crisis compounded the internal adjustment on which the Spanish economy had embarked, exacerbating the decline in domestic spending and employment.

The latest figures indicate that, as in the euro area and the rest of the world, the sharpest phase of contraction in the Spanish economy is now behind us. According to the data released some days back by the INE, activity slipped once more in the third quarter, unlike in other developed countries, although it did so at a quarter-on-quarter rate of 0.3%. This rate was more moderate than in the first two quarters, when the decline was 1.6% and 1.1%, respectively. The fall-off in

activity, which stood at 4% compared with the same period a year earlier, was the result of the marked weakness of national demand, particularly private spending. Only the public components of domestic demand retained positive growth rates, due partly to the inertial component of certain expenditure items (such as purchases of goods and services) and partly to measures adopted to mitigate the decline in demand, such as the State Fund for Local Investment. And, as has been the case since the opening quarters of 2008, the strong contractionary effect on activity exerted by the fall in domestic spending was lessened by the positive contribution of the external sector, largely due to the notable decline in imports.

The strong contraction in demand in recent quarters is helping correct some of the imbalances that had built up in the Spanish economy during the boom period. These include the excesses in the real estate sector, high private-sector debt, the external deficit and the inflation differential. However, the adjustment is operating through a considerable decline in activity and the marked destruction of the general business and employment fabric, which is giving rise to a sharp increase in unemployment.

The previous strong concentration of resources in the real estate market is diminishing most rapidly, with an acute decline in housing starts. Yet although the decline in residential demand has been very abrupt, lower interest rates and the fall in house prices have placed affordability indicators at more moderate levels, which is helping to stabilise real estate purchases in recent months.

In the case of lending to the private sector, we have witnessed increasingly negligible and even negative growth rates, and this pattern will probably prevail over the coming quarters. These developments in lending have a most significant cyclical component, accentuated by the tension on international financial markets. After the strong increase in household and corporate debt ratios in the previous upturn, it was inevitable these ratios would fall to improve the financial position of households and firms, and to assist in the resumption of a sustainable path of spending. The strong adjustment in spending is also bringing about a sharp reduction in the external deficit which, after posting a figure close to 10% of GDP in 2007, may be below 5% of GDP in 2009. The adjustment is based, above all, on the decline in imports and on lower commodities prices; accordingly, for this correction to firm when demand picks up, a more substantial contribution by exports will be needed and, in this connection, our export base and the productivity of our companies must continue to be strengthened.

In terms of inflation, we are also seeing a significant correction, as there has been a negative inflation differential with the euro area for almost a year. In particular, there have been substantial declines in industrial goods prices over the past year, while services prices, traditionally prone to very high rates of increase, have eased substantially and have even been growing at a lower rate

than in the euro area in recent months. Admittedly, this negative inflation differential is very closely linked to the weakness of demand in Spain. But it is a promising sign of the competitiveness on which the pick-up in activity should be based, so it is important that this price moderation should be preserved in the near future.

As I said earlier, there are two adverse consequences of the way in which these imbalances are being corrected: the excessive toll imposed on employment by the crisis, owing to the poor functioning endemic in our labour market, and the deterioration of public finances.

Job destruction began with great virulence in construction and subsequently spread to manufacturing industry and market services. It was centred above all on temporary contracts, given the prevailing duality in the labour market. In recent months employment has continued to fall, although the State Fund for Local Investment has slackened the effect. The unemployment rate skyrocketed from 8% in 2007 to almost 18% in the third quarter this year, when it stabilised due partly to the strong slowdown in the growth rate of the labour force. This slower labour force growth was the consequence of part of the population being discouraged by poor employment prospects and of the return of some immigrants to their countries of origin.

As in other countries, the outlook for the Spanish economy remains uncertain, although this has abated somewhat recently in light of the brighter figures for the world economy. It is likely that the recovery in the Spanish economy will lag that in the euro area to some extent. This is due above all to the marked weakness of investment, not only in the case of housing, but also in that of business investment, given the very low levels of capacity utilisation. While public investment will continue to account for a high proportion of GDP in 2010, this figure will be lower than in 2009.

The outlook for private consumption is more uncertain. The main determinants of consumption will not be favourable, given the foreseeable behaviour of employment and the difficulty of reversing the high unemployment rate. Yet as the decline in households' consumption has been much more drastic than that of their incomes, the saving rate is climbing to very high and indeed unprecedented levels. Hence, if the factors of uncertainty were to abate, consumption might contribute more significantly to the recovery.

Given these constraints, the main support factor of activity in 2010 has to be the external sector. This will be assisted by the earlier recovery of our main trading partners and the relatively favourable course that Spanish exports are following.

Foreseeably, a phase of gradual growth will begin over the course of the coming year, based on a continuing positive contribution of external demand and on a progressive pass-through of the improvement in the world economy to business investment and employment. On average, however, 2010 might still see a moderate decline in activity, the result above all of the carry-over

effects of the negative rates in 2009. The growth path in 2010 might also be affected by the VAT rise announced for next July, since this measure might bring forward some spending decisions to the second quarter, raising demand and activity in this period but reducing them in the second half of the year. This slow path of recovery in activity broadly matches the government's macroeconomic forecasts on which the State Budget for 2010 is based.

The setting I have described highlights the significant challenges the Spanish economy faces. For the recovery to materialise and firm, the Spanish economy must first check and then absorb unemployment, restore health to business and household finances, rebuild confidence in the economy's productive capacity and reduce the large budget deficit.

To achieve these goals, I reiterate that it is vital to adopt an ambitious agenda of reforms. The economic policies pursued since the start of the crisis have focused on countering in the short run a very adverse economic and financial situation, and there is broad consensus that the efforts made have contributed positively to this end. However, now the foundations for a potential turnaround are discernible, the structural problems of the Spanish economy must be addressed to avoid the risk of a scenario of protracted economic sluggishness.

Regarding monetary policy, the cuts in official rates by the ECB are helping alleviate financial pressure in the private sector. And this is a factor which, given the prevalence of floating interest rates in Spain, will continue to alleviate the burden on households and firms over the coming quarters.

Fiscal policy has also contributed to softening the downturn in activity by means of a highly significant budgetary effort that has been greater than that in other developed countries. The cost, though, has been a very swift and sharp rise in the budget deficit which, on the latest official government figures, might rise to around 10% of GDP this year.

Irrespective of how long the cyclical change takes to exert positive effects on the budgetary situation, I would like to draw your attention to the fact that much of the deficit generated over the past two years has a significant structural component; and the recovery, therefore, will not correct this component. Indeed, despite the fact that in the coming years revenue will foreseeably increase owing to the reversal of the temporary effects of some of the activity-supporting measures adopted in recent years, it should be borne in mind that the exceptionally high revenue obtained during the real estate boom will not recur. At the same time, in connection with public spending, primary spending has held at a high growth rate in recent years, attaining levels that cannot be sustained for much longer and which, therefore, it will be necessary to reduce.

In turn, the deterioration in the budgetary position is taking the form of a rapid increase in public debt and, therefore, too, in the amount of resources needed to meet the payment of the interest burden.

It should also be stressed, as various recent past episodes in some developed countries show us, that the dynamics of rising debt can prove difficult to reverse. All the more so when some factors that helped towards its reduction in the past, such as lower interest rates and the high growth of nominal GDP, can no longer be counted on.

The need to reverse the high structural deficits and to prevent the risks linked to debt dynamics from materialising thus evidences the fact that there is no more room for expansionary budgetary policy. Given the fiscal imbalance that has built up, it will be essential to devise a transparent and credible budgetary consolidation strategy for the medium term that will require the adoption of ambitious measures, especially on the expenditure front.

In a setting in which the recovery is still uncertain, the necessary fiscal adjustment should be designed in such a way as to minimise the potential adverse effects on economic growth. That attributes great importance to the composition of the adjustment and, from our own experience, measures based on public spending cuts, especially non-productive spending on consumption and investment, may be most fruitful in this respect. Nonetheless, given the scale of the imbalance it seems clear that certain features of the tax structure will also inevitably have to be revised. Selecting tax measures is never easy, and less so when the tax base is being considerably eroded. Accordingly, the tax instruments that cause least distortion and help reduce fraud should be chosen, so that long-term growth prospects are not compromised. And in this respect, indirect taxes, in addition to offering higher tax-raising potential, are more neutral from the economic efficiency standpoint.

In any event, one of the main risks of fiscal consolidation strategies entailing tax increases is that the increases in revenue may end up being used to finance new spending demands. Consequently, a strict application of the budget is especially necessary to ensure that new revenue is used in full to reduce the budget deficit.

The government has reiterated on several occasions its commitment to budgetary stability, and its intention to resume deficit levels compatible with a balanced budget in the horizon defined by the European authorities in the application of the Stability and Growth Pact rules, which has recently been extended to 2013. The State Budget for 2010 is a first step within this general consolidation strategy.

But we should be mindful of the fact that we are at the start of a long process in which the credibility of the policies adopted plays a fundamental role. To ensure that the medium-term

budgetary objectives are realistic, economic policymakers must convey to economic agents their resolve to exert rigorous control over the deviations in revenue and spending that may occur.

In this connection, and given the high degree of decentralisation of the Spanish State, it is vital that the regional and local governments should be committed to controlling and reducing the deficit through compliance with the principles laid down in the law on budgetary stability. It is particularly important that the regional government budgets that are approved in the coming months should accept the fiscal consolidation strategy as a key objective, that they adopt far-reaching structural reforms on public spending and that they ensure their budget outturns are rigorously in compliance with this objective.

Finally, in light of the huge amount accounted for by the public spending component linked to the deterioration of employment, it should be stressed that the viability of any budgetary consolidation strategy for the Spanish economy will depend on this strategy adopting a job-generating growth pattern that, as occurs in other countries, provides for a significant reduction in unemployment. To this end, the main instruments available to national economic authorities are supply-side and structural reform policies geared to promoting job creation, smoothing the switchover to new productive activities and increasing the economy's efficiency and productivity. The future of the Spanish economy hinges greatly on these policies, not only in the long run but also in the more immediate term.

The priority of these reforms should be to generate a rapid and deep-seated change in the prevailing labour market trends. That requires altering a good number of the institutions that currently regulate this market. In particular, innovative hiring arrangements are needed to facilitate job creation and to overcome the marked segmentation currently in place which has adverse consequences for employee training, job stability and for efficiency and equality in the economy. In turn, collective bargaining should be reformed so that internal organisation and labour costs are better tailored to the specific situation of each company and to cyclical developments, but also so as to equip firms with the flexibility they need to increase productivity.

But there are other measures we should not rule out, even though their effects may take longer to materialise. This is the case, firstly, with education. Undoubtedly, improving education is the most important issue pending for economic growth in Spain. True, we have made progress in some areas; but it is no less true that there are incipient signs that the increase in the level of educational attainment of the workforce observed in the second half of the 20th century is slowing. The reform of the education system, moreover, would complement that of the labour market. This is because the current labour market set-up discourages people from spending longer in education since it fails to differentiate appropriately between skill levels, leaving the young facing temporary contracts or unemployment, with the adverse effects I have already mentioned.

It is also essential to move to boost the knowledge economy so that it may contribute to strengthening technological capital and to bridging the gap afflicting the Spanish economy in this field. This should be done in parallel with pertinent measures to further the liberalisation of goods and services markets, the current regulation of which involves in some cases a diminished level of competition. One key area for progress along these lines is liberalisation in the services sector, as it encompasses some of the most dynamic activities and some of those with most job-creating capacity. Likewise needed is further headway in liberalisation and competition in the network industries, so that the conditions in which inputs are supplied to other productive activities allow Spanish companies to compete on an equal footing with our trading partners. And let us not forget the housing market. Further improvements to rental regulations are needed to make this option more flexible and profitable, so that the purchase of housing for investment purposes is encouraged, thus helping reduce the supply overhang, and broadening the possibilities of meeting the population's demand for residential services.

Finally, I must reiterate that the soundness of the financial system is essential for ensuring the financing flows needed to restore economic dynamism. While the Spanish financial system has shown notable resilience to the direct and indirect effects of the international financial crisis, the intensity of the adjustment the Spanish economy is undergoing against a background of protracted financial tension adds further factors of pressure in terms of asset impairment, an increase in bad debts and a narrowing of bank margins. Faced with these risk factors, not all banks are equally prepared, whereby the availability of appropriate mechanisms, such as those offered by the FROB (the Fund for the Orderly Restructuring of Banks), will help banks face the restructuring necessary with the best results for the functioning of the economy and the least cost to taxpayers. However, I must say that, if reforms are not adopted promptly, high unemployment might be prolonged, which would contribute to increasing financial institutions' difficulties and would prevent the soundness of the financial system from acting, as it has to date, as an essential pillar of economic growth in Spain.

Allow me to conclude by stressing that the Spanish economy is at a decisive crossroads. If far-reaching reforms are not promptly adopted, we face the prospect of slow recovery with high levels of unemployment and public spending. Conversely, if the right - although not easy - decisions are promptly taken, we will be able to resume a path of high growth based on a more productive and sustainable pattern. To achieve this it is vital to apply medium-term stability strategies and ambitious structural reforms, which should be well co-ordinated and credible. In devising these reforms the broadest possible consensus would be desirable, as that would increase their soundness and effectiveness. But clearly conveying to society that the seriousness of the situation requires far-reaching reforms will be of paramount importance. We would thus be taking a decisive step in leaving this crisis behind us, and the foundations would be laid so that Spain may take up a new phase of vigorous growth and high job creation