
Address by the Governor of the Banco de España, Jaime Caruana, to the Spanish Parliamentary Budget Committee

A year ago the world economy was going through a very difficult period, in the wake of the dramatic events of September 11th 2001. Subsequently, in both the United States and Europe, the slackness of productive activity began to be overcome with relative speed, in spite of the direct impact of the terrorist attacks on important industries and of dented consumer and investor confidence throughout the world. However, the recovery phase has begun in a lacklustre fashion in most countries, with the exception of some of the south-east Asian economies.

The flatness marking most advanced economies is partly linked to the slump in prices on the main international stock markets, to heightened uncertainty and risk aversion on financial markets, and to international political tension, which has checked the pick-up in confidence and prompted a significant rise in oil prices.

The Latin American region has been subject in recent months to pressures which have highlighted the structural weaknesses of certain countries and the vulnerability stemming from the dependence of many countries in the area on foreign saving.

The high volatility of world bourses and international political uncertainty make any assessment of the prospects for the world economy in the near future difficult. In principle, the most likely scenario is that activity will continue on the path of recovery initiated, once the adverse affects of the stock market crisis peter out. That said, the risks of more unfavourable developments are not negligible.

Against this background, the euro area economy has proven less buoyant than expected only a few months back. Although the growth rate of GDP appears to have bottomed out in Q4 last year, the rate at which the recovery has begun has been very modest, and it is unlikely that the increase in the area's GDP will be more than 1% for the current year.

This muted expansion in activity is, above all, the consequence of the euro area economy's direct exposure to the international stock market crisis and to its impact on export markets. The marked correction of European bourses (which has been steeper than in the United States so far this year) is partly due to the widespread effects of the US stock market crisis, although it is also a reflection of some specific factors. Certain major corporations have found it notoriously difficult to obtain returns on costly strategic operations, such as mergers or acquisitions, or on third-generation mobile telephony licences. Moreover, the

floods in much of central Europe last summer have damaged the industrial fabric and worsened the financial position of insurance companies already weakened by the loss of value of their financial assets.

A cause for concern has been the decline in gross capital formation in the euro area; the capital goods component fell in Q2 this year to a year-on-year rate of 5%. True, the slackness of investment is largely due to cyclical factors and to the impact of international disturbances. But it also reflects the structural shortcomings still in place, which impair the potential profitability of business projects.

Nonetheless, the course of activity in the euro area suggests that, as from the end of this year or the beginning of 2003, economic buoyancy will increase sustainedly, with the GDP growth rate for the area moving progressively towards its potential, although the risks of an outlook of more persistent cyclical weakness should not be underestimated.

Against this backdrop, monetary policy implementation has been rather complex. Relatively favourable prospects for price stability in the medium term allowed the ECB to accommodate its policy to the cyclical downturn besetting the euro area last year. Interest rates were duly cut by 1.5 percentage points during 2001. They were set at 3.25% in November last year, and have held there to date.

Subsequently, the appreciable deterioration in the economic situation prompted by developments on stock markets has, along with the appreciation of the euro and despite the strong growth of liquidity, lessened the inflationary risks that had begun to emerge. Thus, at the latest meeting of the ECB Governing Council (12th September) it was decided to hold interest rates at their current level further to the assessment that this was in line with the balance of risks affecting price stability in the medium term, which is the primary objective of the ECB.

The public finances of the euro area Member States currently merit particular attention in view of the difficulties some (Spain not among them) have recently faced in meeting their budgetary objectives. I believe it is appropriate to reiterate before this Budgetary Committee my conviction that fiscal discipline is a vital ingredient not only for sustained economic growth, but also for the proper functioning of the Monetary Union. In this respect, the Stability and Growth Pact is a tool of paramount importance for promoting the fiscal policy stance needed to attain or maintain a balanced budget,

while providing sufficient flexibility so that public finances may, in the short term, be adapted to the needs and, in particular, the cyclical position of each economy.

The international and European outlook is conditioning developments in the Spanish economy. The direct impact being transmitted through the decline in goods and services trade flows with the rest of the world is compounded by the fall in share prices on stock markets and the spread of uncertainty and wariness that is holding back household expenditure decisions and corporate investment plans.

Despite this adverse climate, the Spanish economy continues to post a positive real growth rate which, in the first half of the year, has stabilised at 2%. Although it has slowed significantly, this rate of expansion is still considerably higher than in most of our peer countries. Consequently, for another year, the process of real convergence with the European Union will continue to make headway, constituting a suitable reference point for assessing the economy's behaviour.

However, as the external environment has worsened, the improvement in the recovery phase has been deferred. It may thus be necessary to wait until the closing months of the year before the Spanish economy moves firmly onto a path of expansion, the intensity of which will depend on whether the expectations of a recovery in the world economy are confirmed. The growth of the Spanish economy in 2002 on average may thus not exceed 2%. It will then be over the course of next year that its growth rate moves gradually towards 3% or thereabouts, allowing the average rate to exceed 2.5%.

The climate of sluggishness abroad is apparent in the fall in exports of goods and services and in corporate investment cutbacks. Industry has been most directly hit by these circumstances. It is thus domestic components -including most notably buoyant employment - that are sustaining economic growth.

The fact that the employment growth rate in the Spanish economy remains relatively high at a time activity is turning down marks a significant difference from previous cycles when, as you may recall, there were intense bouts of job destruction which ultimately immersed the economy in deep recessions. Conversely, on this occasion, employment is proving a key factor in the growth of household disposable income and in sustaining expenditure (on consumer goods and services and on house purchases).

Household investment in housing remains very resilient and this, along with public investment, means that construction is the most expansionary industry in the current circumstances. But this behaviour is also fuelling spiralling prices on the housing market (a development not exclusive to our economy) in spite of the economic slowdown, and thereby adding a factor of risk.

In principle, the Spanish economy is in a favourable position to join a global recovery if and when this is confirmed. The cycle will foreseeably close with relatively high real GDP growth rates. Moreover, employment is a fundamental underpinning for sustaining activity. Several factors infuse confidence that these new patterns of behaviour will take root. These include notably the levels of macroeconomic stability attained in recent years; the fact public finances are firmly balanced; the reforms undertaken in numerous markets, including the labour market; and wage moderation.

The spurt in the growth rate of prices in the Spanish economy this year is, however, a cause for concern. It is due to a variety of reasons, including most notably the increase in the prices of certain foods and the rise in oil prices. The growth rate of the CPI at the end of the year will not be far off its present rate since, although the rate of increase of its more stable components will foreseeably be cut, energy prices are expected to continue increasing owing to the base effect arising as a result of the heavy price falls recorded in the closing months of the previous year.

As these factors abate in 2003, the rate of inflation will progressively slow. But our inflation differential with the euro area countries must fall durably; otherwise, the economy's competitiveness foundations will be punctured.

The Spanish economy's resilience (even during the recent slowdown) and historically low interest rates have helped provide for the continuous increase in household and corporate debt.

In the case of households, the intense resort to credit in recent years has essentially been associated with the development of the housing market and the growing use of mortgage loans. Although debt levels do not differ from the average for European economies, the related growth rate is still very high, despite the economic slowdown.

In turn, corporate debt, against a backdrop of slack investment, is closely linked to the foreign asset acquisitions recently made. In this

respect, the problems besetting certain Latin American countries are restricting certain companies' room for manoeuvre. Overall, however, the financial position of companies remains sound and their profitability ratios high.

In sum, private-sector debt cannot continue to grow at the rates seen to date. That would involve a worsening of the sector's financial position and an increase in its vulnerability to unexpected shocks. Were such risks to materialise, they would erode the future spending capacity of households and firms and therefore weaken the domestic underpinning of economic growth. It is thus important that the recovery should be compatible with a pick-up in private saving and with a clear easing off in the resort to borrowed funds. From this standpoint, an orderly containment of house price rises should contribute to checking household debt and to securing their financial position without interfering in their consumption plans.

In the macroeconomic scenario described, the State Budget for 2003 renews its commitment to budgetary stability, which has been at the core of fiscal policy in recent years. As the Budget is subject to the Budgetary Stability Act, this reinforces the disciplining elements needed to attain healthy public finances which, in the face of adverse cyclical situations, allow the leeway provided by the automatic stabilisers to be used and the budget deficit to be held at moderate levels, in line with the commitments entered into with the Community.

The goal of a balanced budget for 2003 is appropriate from the standpoint of the Spanish economy's cyclical position. If, however, risks of lower growth were to materialise, that could give rise to a modest deficit. The budgetary policy stance is also appropriate from the perspective of the commitments made in connection with the Stability and Growth Pact and of the challenges Spanish public finances will have to meet in the medium term. Such commitments will allow the tax burden on households and firms to be lessened and, at the same time, they will enable public spending items essential for the economy's productivity and long-term growth potential to be maintained.

In this respect, the reform of personal income tax is a pivotal element of the budgetary programme for 2003. Beneficial effects for output, employment and disposable income are expected from the reform, which should place the Spanish economy back on an expansionary path. The present cyclical conditions of the economy are, however, very different from those prevailing at the time of the last tax re-

form. Consequently, it will be very important over the course of next year to monitor in great detail the actual cost of the reform in terms of forgone revenue.

I should like to conclude by reiterating the importance of macroeconomic and financial sta-

bility as a vital basis for sustained economic growth. Pursuing such a stance has proven very fruitful in recent years and, at times of uncertainty and tension on international markets, it is particularly well-founded.

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