

APPEARANCE BY THE GOVERNOR OF THE BANCO DE ESPAÑA, MIGUEL FERNÁNDEZ  
ORDÓÑEZ, BEFORE THE PARLIAMENTARY BUDGET COMMITTEE

## Appearance by the Governor of the Banco de España, Miguel Fernández Ordóñez, before the Parliamentary Budget Committee

Ladies and gentlemen,

This appearance, as part of the Parliamentary discussion of the State budget for 2007, is my first as Governor of the Banco de España before the nation's elected representatives. As this is my first testimony, allow me, before going into specific details, to refer to the importance I attribute to relations with Parliament.

The Banco de España is entrusted with specific functions relating to macroeconomic and financial stability of far-reaching scope for the performance of the economy, economic growth and the welfare of citizens. To perform these functions it has considerable institutional independence, under the terms of the Law of Autonomy and the treaties of the European Union, which is its main identifying feature.

The responsibility exercising this independence entails demands an appropriate explanation of the courses of action followed in relation to the objectives laid down and transparency mechanisms that allow for monitoring by the public at large, economic agents and financial markets. From this standpoint, appearances by the Governor before Parliament are of great importance and play a key role when communicating the analysis of the economy on which the Banco de España's conduct is based. I am convinced these appearances will be very fruitful for fulfilling the mission entrusted to us by law.

I stand before you at a time at which the latest data reveal the firming of the European recovery, as part of the expansionary climate of the world economy, and which, in our case, have led to an upward revision of the Spanish economy's growth rate. The latest Spanish National Accounts figures have exceeded the forecasts of the various agencies and portray a picture that confirms the prolongation, with renewed buoyancy, of what is already a long-lasting upturn.

Adding to the continuity of the expansionary factors accompanying the setting in place of a stable macroeconomic regime are the step-up in the demographic impulse from immigration and from growing female participation, and, more recently, the recovery in the euro area. I feel I should stress that this recovery and the gradual withdrawal of the expansionary stance of the single monetary policy (which naturally accompanies it) are taking place at a particularly timely juncture for the Spanish economy. The combination of both movements, on one hand, tends to sustain growth via the impulse of external demand, while on the other, the adjustment of monetary conditions is conducive to the containment of domestic demand and helps rebalance the composition of growth.

We thus face conditions which, in principle, allow us to project the current scenario of economic dynamism onto the horizon for the coming years. But it is a scenario that is not free from either external or domestic risks, especially as regards its long-term sustainability. These risks require prompt and effective economic policy action so as to prevent or hinder their emergence.

At a more detailed level, I shall firstly refer to the euro area's situation in the current international context, and to the single – and indeed our – monetary policy. Subsequently, I shall move on to the situation of the Spanish economy, within which the State budget for the coming year is framed.

During the current year, the international economic outlook has been marked by the continuing notable strength that global activity and trade have been exhibiting in recent years, and which is proving extensive to most of the main geographical areas. This buoyancy has been maintained despite oil and non-energy commodities prices that remain high, although they have turned down significantly from their highs during the summer.

The outlook for the medium term points to the continuity of the expansionary phase of the world economy, albeit at a somewhat more moderate pace. These forecasts are shrouded in uncertainty owing to the persistence of macro-financial imbalances, the uncertain course of oil prices (despite their recent moderation against a rather unstable geopolitical background) and the possibility that the slowdown in the US economy will be on a greater scale than currently anticipated. Accordingly, although the most realistic scenario is encouraging, there are some downside risks.

Against this global backdrop, we have witnessed the long-expected firming of the recovery in the euro area economy during the year. Following the slackness of recent years, activity gathered growing momentum and led output to quicken to an increase of around 2.5% at the end of the first half of the year. Significantly, after the initial impulse provided by the external sector, strengthening domestic demand has begun to take up the baton. Underpinning it has been the buoyancy of investment, spurred by favourable financial conditions, and, moreover, the recovery in corporate earnings and the restructuring of firms' balance sheets. Private consumption has also improved, albeit hesitantly, and will progressively firm insofar as the recovery in employment is confirmed. In the medium term, the current economic robustness is most likely to run into the coming quarters, whereby GDP will maintain growth rates around potential output. Naturally, this favourable outlook broadly shares the same risks as those described for the international environment.

Turning to inflation, the growth rate of the HICP had held persistently above 2% until August, this figure – allow me to remind you – being the reference used for the Eurosystem's definition of its price stability objective. It did however dip to 1.8% in September, further to the recent correction of energy commodities prices, as the indices referring to product baskets excluding these goods had generally been behaving more favourably. The absence to date of underlying inflationary pressures is likewise discernible in the moderate course of labour costs and the indicators of inflationary expectations. However, there are upside risks to inflation in the short and medium term, since the more dynamic economic context might be conducive to a gradual emergence of the indirect effects of the past rises in oil and the increase in wage demands on the non-energy components of the HICP.

The monetary policy pursued in recent years has contributed effectively to improving the economic situation and outlook for the euro area as a whole that I have just described. In particular, despite the recurrence of upward pressures on the general level of prices, the ECB has managed to keep inflation expectations at levels compatible with its priority goal, which reflects the high credibility it enjoys. This has been propitious to the containment of corporate costs, to strengthening agents' confidence and, as a result, to moderating the adverse effects of the rise in oil prices. All these developments attest to the benefits associated with the central bank's independence and with the clarity of its strategic objectives.

Economic policies in the euro area, for their part, face three major challenges: population ageing, globalisation and technological change. Firstly, the foreseeable budgetary impact of the changes ahead in the demographic structure of the population means the measures aimed at countering such effects are very important, as is the application of the current institutional

framework following the reform of the Stability and Growth Pact. In this respect, it is particularly important for countries running an excessive deficit to harness the improvement in the march of the economy to reduce their imbalances in a durable fashion.

Secondly, technological progress and the changes brought about by the incorporation of new geographical areas to the global economic scenario require structural reforms conducive to competitiveness to be set in train. These are vital if it is intended to successfully transform the current phase of economic recovery into a sustainable expansion. The unsatisfactory performance of euro area GDP since the start of the current decade reflects both the slowdown in labour productivity and, despite recent progress, the still-insufficient use of this production factor. To reverse this trend, certain aspects of product and labour market regulation must be reviewed so as to provide for the reallocation of resources as required by the twin phenomena of globalisation and technological change. Europe has decided to advance in this area by means of the reforms and timeframes contained in the Lisbon Agenda. This is an excellent programme, but fulfilling it will require resolve by national economic policymakers and broad-based political and social consensus.

The sustained improvement of European citizens' welfare requires, in any event, the involvement of all areas of public policy. Accordingly, the current smooth functioning of institutional relations between the central bank and national and Community economic authorities is essential in my view. These institutional arrangements are based on the monthly presence of the President and Vice-President of the ECB at the meetings of the Eurogroup, and of the Chairman of the Eurogroup and the European Commissioner for Economic and Monetary Affairs at the meetings of the ECB Governing Council. Experience shows that interaction is very fruitful when the agreed distribution of responsibilities is adhered to and, in particular, when the monetary authority's independence – the cornerstone of its credibility – is observed.

As earlier indicated, it is precisely the credibility gained by the central bank that has allowed it to adjust monetary conditions recently to the sluggishness of the economy without jeopardising the fulfilment of its priority goal. Likewise, if the current expectations of economic growth are confirmed, monetary policy will have to continue gradually withdrawing the accommodative stance still in place. In this connection, the normalisation of monetary conditions may be seen as the natural outcome of the current economic buoyancy and of the need to ensure its compatibility with the maintenance of price stability.

From the standpoint of the Spanish economy, the improvement in the euro area and the gradual normalisation of monetary conditions I have referred to frame a scenario propitious to the prolonged dynamism of economic activity and of employment.

In the first half of 2006 the Spanish economy continued to show marked strength. Indeed, economic activity could be seen to be moving on a mildly accelerating path in Q2, which placed GDP at a year-on-year growth rate of 3.7%. The latest Quarterly National Accounts figures available exceed the growth previously forecast for the first two quarters of the year by a fraction of a percentage point. However, in terms of the intensity and composition of growth, that chiefly reflects the revisions to the rate of increase of GDP in 2004 and 2005, for which a somewhat less negative contribution of the external sector than initially estimated can be seen.

The prolongation of the expansion in 2006 has continued to be underpinned by the resilience of national demand. And while this variable began to slow to some extent, this has been offset by the gradual improvement in the contribution of the external sector to growth. These data

appear to indicate an incipient rebalancing of the composition of growth, to which the still-moderate effect of the adjustment of monetary and financial conditions on expenditure and the economic recovery in the euro area would both be contributing.

Of the different components of national demand, only private consumption and government consumption have shown signs of slowing slightly in the year to date, while investment in construction has retained notable strength and the rate of increase of investment in equipment has stepped up in Q2 after dipping slightly in mid-2005.

The slowdown in private consumption has been the outcome of factors acting in opposite directions. Among those that may have checked household consumption are the erosion of purchasing power, which has come about in the face of the high inflation rates recorded in the first half of the year, and the effect of interest rate rises, which might be prompting some correction in the tendency of the household saving ratio to fall in recent years. Conversely, the continuing buoyancy of job creation – standing at a rate of around 3% – and the persistence of a potentially still-powerful wealth effect would have continued to sustain the dynamism of household consumption. In this respect, although the rise in real estate wealth is beginning to show signs of slowing, in recent months there have been significant stock market gains that might have countered this effect.

As regards the different components of gross capital formation, investment in construction has, as mentioned, remained considerably stable. The growth rate of this variable exceeds 5%, in a setting in which the demand for housing has remained most resilient and in which the non-residential building and civil engineering segments have continued to show signs of intense activity. Of note is the rise in investment in equipment, which continues to be the most dynamic component of demand, reflecting greater export activity and the improvement in the industrial sector, against a background of corporate profitability and financial conditions highly propitious to expanding productive capacity.

But perhaps the most notable aspect of the current situation is the incipient easing in the pressure from net external demand, whose negative contribution to output growth has declined in recent quarters to around 1 pp. The recovery in goods exports, boosted by the strong increase in world trade and by the take-off of economic activity in the euro countries, accounts virtually in full for the relief from the negative contribution of net external demand. Imports, meanwhile, have remained very buoyant, reflecting the increase in final demand. Against this backdrop, export shares appear to have stabilised after falling off last year, although import penetration has continued to increase.

It is not easy to diagnose the scope of this improvement in the external sector, but the lack of significant changes in the course of the price-competitiveness indicators – which have generally continued to worsen in the year to date – might slow and even interrupt the improvement in the external sector.

So far in 2006 the Spanish economy has continued to display intense employment generation capacity. As a result, the labour market has continued to absorb a highly dynamic labour supply while the unemployment rate fell to levels not seen since the 70s, posting a figure of 8.5% in Q2. The latest labour market indicators confirm the prolongation of this trend.

Labour costs rose slightly in the first half of 2006, with increases of around 3%. These are, however, lower than those negotiated in collective bargaining agreements if the effect of the indexation clauses is taken into account. This discrepancy may be due to the effect on ag-

aggregate wage growth of the lower wages of the sizeable numbers joining the labour market, where immigration plays a significant role. Despite the minor upward revision in the rate of increase of productivity inferred by the latest National Accounts figures, the differential between respective Spanish and euro area labour costs per unit of output has continued to widen, although in manufacturing, where productivity gains are proving significant, some stabilisation can be seen for the first time.

On the prices front, the inflation rate moved on an upward course in the first half of the year, driven by labour costs and the widening of margins, but above all by higher oil prices, which I referred to earlier. Against this background, the year-on-year rate of increase of the CPI held at close to 4% to July, although it dipped in August to 3.7% and the increase in the harmonised index for September points to a further cut to 3%, due mainly to the marked fall in energy prices in the past two months. It should not be forgotten, however, that underlying inflation has held persistently at a rate of around 3%, above the figure for the past two years, and that the consumer price differential with the euro area has remained at a high level.

Despite the improved export performance and the slowdown in spending, the external deficit continued to increase both in nominal terms and as a percentage of GDP during the first half of 2006, albeit at a lesser rate than that observed in the last two years. Here, too, dearer oil has played a significant part in the deterioration.

The still-incomplete and fragmentary economic information available for 2006 Q3 points to the continuing strength of economic activity, suggesting that the increase in GDP on average in 2006 might be slightly higher than in 2005.

The outlook for 2007 points to a slight slowdown in GDP growth and to the continuity of the patterns observed in recent quarters. National demand is projected to hold on a mildly slowing path and there are expected to be further improvements in the contribution of net external demand. This profile would be in line with the macroeconomic scenario on which the State budget for 2007 was based, although the starting point would be somewhat higher growth rates in 2006. As regards inflation, the outlook for the rest of the year points to a slowdown in the year-on-year rate of the CPI, owing largely to the lesser contribution of energy prices to the overall index, although average growth will ultimately be higher than that in 2005.

The outlook I have sketched is one of sustained growth and the start of a gradual correction of imbalances over the course of 2006 and in the opening quarters of 2007. This picture is not, however, free from risks in the medium term. In the international domain I have already mentioned the risks to the prospects for the world economy and the uncertainty still surrounding the intensity of the European recovery. Domestically, I should particularly like to highlight the risks stemming from the continuing inflation differential and from high household debt.

Sustaining price increases higher than those in the euro area is a cause for concern if the indexation mechanisms built into collective bargaining prolong the inertia of price rises, with the subsequent adverse impact on competitiveness. In turn, the fact underlying inflation should have stabilised at a relatively high rate suggests that some effects of dearer oil may be passing through more permanently to other prices. That might all bear negatively on the ongoing improvement in exports. Against this background, containing inflation and bringing it closer to rates compatible with the concept of price stability is needed to pursue the rebalancing of domestic and external demand and to ensure continuing economic dynamism in the medium term.

As to the risks stemming from the increase in private-sector (especially household) debt and from the pronounced growth in residential investment, I should first remind you that these are phenomena consistent with the recent changes in our economy and, notably, with the low level at which interest rates have been holding.

However, the financial position of agents and, therefore, their propensity to spend have been becoming more sensitive to changes in their income, in interest rates and in house prices. Such sensitivity becomes all the more significant when interest rates are in an upward cycle and house prices are tending to slow. Nonetheless, the financial position of households and firms is healthy and provides a sound basis for adaptation to interest rate levels in keeping with the greater economic dynamism of the euro area. It cannot be ruled out, however, that a portion of lower-income indebted households and of real estate services companies may be vulnerable.

In any event, the environment of price stability, which bounds the foreseeable range in which interest rates may move, and the forecast of a gradual slowdown in house prices (to which the latest official published data point) contribute to dampening these risk factors. Further, the solvency of the financial system and the healthy position of public finances, which I shall refer to later, represent an important safety valve for maintaining the general stability of the economy.

In short, the growth outlook for the Spanish economy in the coming quarters is a relatively healthy one, whose continuity in the medium term requires further headway in containing domestic demand and in expanding aggregate supply response capacity. In this setting, economic policies should contribute to attaining these objectives.

I referred earlier to the single monetary policy and mentioned the fact that the gradual withdrawal of its expansionary stance is occurring at a particularly timely moment for the Spanish economy, since the adjustment of monetary conditions is conducive to the containment of domestic demand and helps rebalance the expansion.

As to fiscal policy, the latest forecasts for the general government balance in 2006 point to a surplus of 1.1%, 0.2 pp up on the figure set in the last update of the Stability Programme (0.9% of GDP). An end-year result for public finances around this figure would suffice to meet comfortably the European fiscal requirements established under the Stability and Growth Pact and to extend the declining trajectory of public debt, the ratio of which in proportion to GDP might stand below 40% at the close of the year.

This improvement in the fiscal position is indicative of the fact that the Spanish economy has been posting higher-than-forecast growth, and that revenue from the main taxes has more than exceeded the estimates made in the budgetary programming exercise.

The draft State budget for 2007 sets an overall general government surplus target of 0.7% of GDP, under a macroeconomic scenario which, as I mentioned, entails a slight slowdown in GDP. The continuity of the economic boom scenario and the foreseeable extension of buoyant tax revenue should enable this objective to be exceeded. And that despite the confluence in 2007 of a series of factors that will tend to reduce revenue, such as the entry into force of the personal income tax and corporate income tax reform, the new EU financial perspectives and specific elements of the labour reform enacted last July. The attainment of a higher-than-programmed surplus, in line with that in recent years, would be more in step with the role that corresponds to fiscal policy in the current circumstances of the Spanish economy. This is a

policy stance that should not be relaxed. The sound results obtained by the Spanish economy in recent years illustrate clearly how fruitful budgetary stability strategies can be and their full compatibility with the maintenance of prolonged phases of economic growth.

The spending policy priorities incorporated into the Budget are geared to areas of great importance for improving productivity, such as increased resources for education and innovation and higher investment in infrastructure. It is thus important to oversee the efficiency of the measures undertaken, so as to ensure that the increase in resources makes for effective improvements in capitalisation and productivity in the medium term.

To make further headway in improving the structural fiscal position, it is vital to raise the efficiency of the different tiers of government in managing expenditure. In this respect, it should be recalled that the State executes only 20% of general government public spending and that, on recent estimates, it will run a fiscal surplus for the second year running in 2006, which will continue into 2007 according to the projections of the draft State budget for next year. It is therefore essential to obtain the support of the Regional (Autonomous) Governments, which continue to post a budgetary deficit (and will do so in 2007). The aim is not only to ensure further progress in improving the general government fiscal position, but also to bring about more efficient management of spending by the Regional Governments, which account for more than 35% of total expenditure.

These efforts will contribute to building more suitable foundations to address the challenges posed by ageing and the undertaking to meet the requirements derived from social protection in situations of dependency.

In terms of supply-side policies, efforts should focus on achieving more flexible factor and product markets that help the Spanish economy adapt to an increasingly competitive environment and to efficiently use the productive resources available. That will require retaining the current capacity for job creation and generating, at the same time, productivity gains. The National Reforms Plan lays down a series of measures geared in this direction, which should be resolutely and ambitiously applied. However, there are certain areas in the economy, such as the labour market, where reform measures must continue to be pushed through.

The picture that emerges from the recent information I have set out is that of an economy that has retained its dynamism with renewed momentum and with a tendency to rebalance the factors supportive of growth. However, the risks to its long-term sustainability, on which the Banco de España has warned, remain present. Accordingly, it would be advisable to remain cautious and to push through the outstanding reform agenda. In this way, the Spanish economy might harness the opportunities offered by the prolongation of the long upturn it is currently experiencing and continue progressing in the medium and long run in respect of convergence towards the levels of welfare in the more advanced economies.

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