

TESTIMONY OF THE GOVERNOR OF THE BANCO DE ESPAÑA,
MIGUEL FERNÁNDEZ ORDÓÑEZ, TO THE PARLIAMENTARY COMMITTEE
ON FINANCIAL AFFAIRS

**Testimony of the Governor of the Banco de España, Miguel Fernández Ordóñez,
to the Parliamentary Committee on Financial Affairs**

Ladies and gentlemen,

Let me first say how grateful I am for the opportunity to appear here today to share with you the view of the Spanish economic situation portrayed in the *Annual Report* of the Banco de España. The publication of this report is a long-standing landmark that allows us to reflect on and recap the opportunities and challenges facing our economy. It is a particular pleasure for me to share these reflections with the people's representatives.

As you know, our country's economic policy arrangements are heavily influenced by membership of the Economic and Monetary Union (EMU). Accordingly, for me, in my capacity as governor of the Banco de España, the ideal starting point for addressing the current juncture of and outlook for the Spanish economy is the analysis of the European Central Bank's monetary policy.

Over the last 18 months, the progressive firming of the recovery in the euro area has given rise to the emergence of risks to price stability in the medium and long term. In the face of this, the ECB has been watchful of the possible materialisation of such risks, its aim being that monetary policy should continue to be of a pre-emptive nature. That has led to a progressive change in policy stance. In December 2005, the Governing Council decided to put an end to a period of two and a half years during which official interest rates had held unchanged at 2%. This had been a historically very low level for the euro area countries, even those with a long-dated tradition of stability. The successive rises subsequently (on a total of eight occasions) placed the main rate at 4%, which has enabled progress towards the normalisation of the monetary conditions in place to be made.

In recent years, the accommodative stance of monetary policy has been assisted by an ongoing notable degree of wage moderation in the euro area (albeit with substantial differences from country to country), which has helped limit the inflationary impact of the rise in oil prices. Also contributing to the containment of inflationary pressures have been factors such as relatively low capacity utilisation until recently, the growing presence of new competitors on the international economic stage and the appreciation of the euro.

However, in recent months monetary policy has had to ensure the control of potential inflationary pressures arising as a result of the impact of more buoyant economic activity on price and wage formation mechanisms. In any event, despite the increase in interest rates, monetary conditions remain conducive to the expansion of domestic demand, the recovery in which appears to be fully and firmly under way.

Indeed, the economic growth outlook for 2007 in the euro area is clearly favourable, given that the information available for the first half of the year points to even greater dynamism than that expected back in January. The resilience of activity is being led by forceful investment which, despite the increase in borrowing costs, continues to be very encouraging thanks to the sound corporate financial position, against a background of rising capacity utilisation. Admittedly, though, the latest data on household spending continue to show that this demand component is lagging the global cycle of expansion somewhat.

In any event, improved employment expectations and the optimism of households reflected in confidence surveys augur a strengthening of consumption over the course of the coming

quarters. In turn, the dynamism of worldwide activity may be expected to continue abroad, meaning that, under the most likely scenario, the prospect of a slight easing in activity in some regions should not be an obstacle to maintaining the soundness of euro area exports.

These favourable prospects are, however, subject to certain downside – and predominantly external – risks in the medium and long term. This is due above all to the possibility that the slowdown in the US economy will prove sharper than currently expected, that there will be further rises in oil prices, that the optimism on global financial markets will wane or that there will be a disorderly correction of global imbalances.

On the prices front, inflation may benefit in the coming months from certain transitory effects. In the medium run, which is the relevant horizon for monetary policy decision-making, forecasts point to rates of around 2%, but with upside risks stemming essentially from the possibility of labour factor costs growing more than expected. It is thus important that wage settlements should hold on their current path of moderation and reflect a sufficient degree of differentiation on the basis of the specific conditions in each industry and of the productivity of each company.

Naturally, future monetary policy will be marked by the course of the factors of risk for inflation containment that I have mentioned. The ECB Governing Council will rigorously and continuously monitor the factors affecting its overriding priority, and it will act resolutely to maintain inflation expectations at levels compatible with price stability. As it has done to date, the Governing Council will attempt to ensure its decisions are foreseeable, regularly indicating the way in which new information confirms or qualifies its assessment of relevant macroeconomic prospects. At the same time, it will avoid taking on board pre-set commitments that restrict its room for manoeuvre in the light of newly available information.

I should say that, for the Spanish economy, the normalisation of monetary conditions is proving particularly appropriate. First, because it contributes to preserving stability and the sustained growth of our trading partners. Second, because it is also helping us to attain a more balanced composition of spending, to achieve a degree of moderation in the demand for financing and to contain house price rises.

Let me move on to discussing the essential features of recent developments in the Spanish economy. As the *Annual Report* indicates, the expansionary phase in train since the mid-90s continued in 2006. GDP growth rose to 3.9%, compared with 3.5% the previous year, outpacing once again the forecasts made at the beginning of the year. On the expenditure side, the counterpart of this increase in activity was a mild slowdown in domestic demand and a sharp improvement in the contribution of net external demand to output growth, thereby making for more balanced growth.

These trends continued into 2007 Q1, and the increase in GDP rose to 4.1% (a rate slightly higher than that at end-2006), as a result of a further slowdown in national demand and of a fresh improvement in the contribution of the external sector to output growth.

The expansionary dynamics of the Spanish economy continue to be underpinned by the stimuli provided by monetary and financial conditions that remain conducive to buoyant expenditure and activity. Naturally, however, such conditions are less propitious following the interest rate rises made over the past 18 months. Yet at the same time, labour supply has continued to increase as a result of the scale of migratory flows and of the rise in female participation. The

growing availability of labour resources has enabled buoyant spending to translate into increases in activity and employment, and has seen cost and price pressures remain relatively contained. Against the background of the increased flexibility of the economy's adjustment mechanisms and of macroeconomic stability, all the foregoing developments have ensued despite the intensity of oil price rises in the first half of last year.

Adding to these factors in 2006 was the sound behaviour of the world economy, and in particular the recovery in the euro area, which is boosting exports following several years of sluggishness. This is enabling the buoyancy of imports to be offset, in a setting of resilient final demand and highly competitive import prices. As a result, the contribution of net external demand to output growth is improving, although the nation's net borrowing requirement continues to widen, albeit at a lesser pace than in recent years.

Turning to household expenditure, private consumption and residential investment remained strong in 2006, underpinned by the expansion of disposable income, by high confidence levels (spurred perhaps by the favourable outlook for employment and permanent income) and by wealth gains, albeit on a lesser scale than in the preceding years owing to the gradual slowdown in house prices. The relative tightening of monetary and financial conditions had, as I indicated in my last appearance before this same Committee, a limited impact on both components of spending.

However, both consumption and residential investment slowed slightly in 2006 from the high levels reached in previous years, and this deceleration continued into the opening months of 2007. In the case of consumption, this trend would chiefly be reflecting the mild slowdown in disposable income and in wealth. In that of residential investment, it would be the changes in interest rates and expectations of lower gains that have begun to dampen the demand for housing, as apparently corroborated by the profile of slowing house prices.

Throughout this period, the household saving ratio has continued to decline. And this, combined with the dynamism of residential investment, has prompted an increase in the net borrowing and indebtedness of households. Nonetheless, the rate of increase of lending to households began to show signs of turning round in the closing months of 2006, a trend that has continued to date in 2007 and which probably reflects the impact of the rise in the cost of financing. These developments have been determined by the slowdown in loans for house purchases, while the pace of resources earmarked for consumption has stabilised at a relatively high rate.

As to the behaviour of non-financial corporations, business investment remained strong throughout 2006, and has been so in the opening months of 2007, in response to highly robust demand and corporate earnings conditions that are offsetting the effect of the rise in interest rates on investment decisions. Indeed, significant equipment investment plans were set in train in 2006, while major corporate acquisition operations were carried out aimed at diversifying business areas, in the light of the maturity of specific productive activities, and at making Spanish companies more international. Set against this, the sector's net borrowing increased and there was growing resort to borrowed funds, which has continued into the opening months of 2007, prompting an increase in corporate debt ratios.

Throughout this process, productive activity, derived from the economy's supply-side conditions, is responding quite flexibly to the expansion of spending, underpinned – as earlier stated – by the continuing robustness of employment. The strength of the industrial sector in particular should be underscored; it rose vigorously throughout last year and continues to expand at

a high rate following several years of sluggishness. The construction sector also showed a sustained expansion, and is only evidencing slight signs of slowing after such a sharp and extended rise. It is precisely this flexibility in the supply-side response, along with the economy's improved adjustment capacity, that has helped reconcile this prolonged period of buoyant demand with a phase in which wage costs have remained relatively moderate, despite the dynamism shown by collectively bargained wages last year.

Notwithstanding, the inflation rate sustained average growth of 3.5% in 2006, widening the differential with euro area inflation. And if the energy component – which was particularly dynamic last year – is stripped out, the related rate was 3.1%. The behaviour of prices in the first half of 2007 has proven more favourable, although energy prices are once again playing a central role. However, the core inflation rate is holding stable at a rate of 2.5%, and certain key items, such as services, are at 4%, meaning that once the favourable effect of the fall in energy prices has been exhausted, inflation may rise somewhat.

The Spanish economy has thus moved into 2007 with notable dynamism and with a more balanced composition of spending. The mild slowdown in domestic demand and the improvement in net external demand have continued, while business investment has begun to gather pace, taking up the baton from residential investment.

Set against this picture of continuity of dynamism in the short term, the sustainability of growth over a longer horizon is becoming very important. In this respect, and as the Banco de España has indicated on many occasions, the normalisation of Spanish household and corporate spending and debt patterns is considered a necessary condition for ensuring the stability of growth. Given the less benign financial conditions, the gradual slowdown in house prices and the mild easing of credit have provided for some headway, albeit limited, in the ongoing adaptation by Spanish households to the progressive withdrawal of the monetary stimulus.

In the corporate realm, however, the presence of other factors has meant that the tightening of interest rates has scarcely been reflected in the sector's behaviour in respect of investment and indebtedness. Foreseeably, the adjustment of financial conditions will ultimately give rise to more moderate debt and spending, thus reducing companies' financial risks and ensuring the continuity of investment in the medium term.

The Spanish economy must also be prepared to meet the challenges of phenomena such as globalisation and demographic developments. The latter have been highly dynamic owing to the intensity of migratory flows, but in the long run a process of marked ageing will unfold.

We must therefore improve our capacity to compete, through a closer alignment of our costs and prices to those of our main trading partners and a genuine improvement in the quality and functioning of our productive system, the reflection of which should be greater productivity gains. Such gains are particularly important for furthering real convergence, once the impulses arising from the increase in the rate of employment lose momentum as we draw closer to a relatively low level of unemployment.

There is a considerable onus on economic policies to adopt the most appropriate measures that enable these challenges to be addressed. The monetary policy of the European Central Bank has, through the gradual increase in its key interest rates since late 2005, allowed financial conditions to be brought closer to levels more in keeping with the requirements of the Spanish economy, although these conditions are still accommodative. In these circumstances,

it is for the policies that remain in the hands of national authorities to assume the role of mitigating the risks inherent in a boom cycle as long as that which Spain has been experiencing and to shore up, in parallel, the economy's growth potential.

The reforms needed to increase the economy's potential require time if their full impact is to be exerted. Accordingly, the current economic boom should be harnessed to define such reforms ambitiously and to implement them speedily.

Fiscal policy is an important instrument for achieving the foregoing goals. Here, and from a short-term standpoint, the strength of revenue in the early months of the year allows us to anticipate, as in previous years, higher-than-budgeted revenue growth. Given the cyclical position of the economy, there should be assurances that buoyant revenue is earmarked to improve the existing fiscal surplus. This strategy should be accompanied by an expenditure control drive, so that greater revenue does not result in additional increases in spending. The budget outturn over the rest of the year and the preparation of the budget for the coming year should be on this basis.

Naturally, the final outcome of a fiscal policy stance in a State as strongly decentralised as Spain hinges crucially on the collaboration of all tiers of government, and in particular of the Autonomous (Regional) Governments, which are responsible for many areas of spending and should, therefore, resolutely adopt the foregoing guidelines.

This budgetary strategy is also appropriate from a medium-term perspective. The dynamism of public revenue has a temporary component, linked to the strength of national demand, and in particular of the real estate sector. Consequently, a greater degree of consolidation will broaden the room for manoeuvre available in the event of any potential deviation from the high-growth scenario. Likewise, bearing in mind that the main challenge to public finances continues to be that of the impact of population ageing on pensions and health spending, an extra fiscal consolidation drive would enable this impact to be tackled from a better vantage point. In any event, though, a deeper reform of the pensions system should also be undertaken, aimed at ensuring its sustainability in the long run.

Finally, the above-mentioned strategy should be pursued in a manner compatible with the improved efficiency and quality of public finances. There is a need to generate the right economic incentives for economic agents, to eliminate the undesirable distortions of State intervention and to enhance factor endowment, in particular human and technological capital via education and research.

The role of fiscal policy in respect of long-term growth is, however, limited and should be supplemented by the application of structural policies. Such policies should be defined in such a way that they continue to enhance the degree of flexibility and responsiveness of supply to economic conditions and the economy's growth potential.

The supply-side response primarily depends on the proper functioning of the labour market. The strong dynamism generated by high migratory flows and by growing female participation has injected forceful flexibility into the labour market. But in the long run the institutional framework must be better adapted so as to provide more stable foundations for the efficient use of labour resources, increasing the possibilities of employment and of income generation for the entire population. As I stated in my address to the Governing Council of the Bank, this should be brought about without forgoing the good industrial relations achieved.

Let me conclude by saying that any boost to productivity requires an improvement in the quality of human capital and the strengthening of the competitive environment in which companies pursue their business, so that the appropriate incentives for business investment and the development and diffusion of innovation may be generated. In this connection it will be necessary to persevere with and further the liberalisation processes undertaken in recent years, and to move towards defining a simpler and more transparent regulatory framework.

Thank you.

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