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## **Interview with the Governor published in Financial Times**

Full transcription

Pablo Hernández de Cos, Governor of Banco de España

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### **Spain's economy has been slower to recover from the pandemic than many other European countries. But it is catching up fast. Is the country set to outperform in the coming years, and if so, why?**

The latest National Accounts data for Spain contained a significant upward revision to GDP growth from 2021, similar to what has happened in other countries. Now, it is estimated that Spanish GDP regained its pre-pandemic level by mid-2022, about one year later than in the euro area as a whole. However, as you say, more recently Spain has been catching up. In the first and second quarters, Spain had growth rates of 0.6 per cent and 0.5 per cent, compared with 0.1 per cent in both quarters in the euro area. Sectoral factors are the main reason for this outperformance. The fact that the services sector is much more important in Spain than in the euro area is absolutely key to explaining these developments. Specifically, the fact that we are much more dependent on tourism has helped us in this case, given the sharp recovery in tourism in 2023. The fact that we are less dependent on manufacturing is another key factor. Lastly, we are also much less dependent on exports of goods to China. These are the main reasons why activity has been stronger and more resilient in Spain. So now the big question is: will it last?

### **And what is the answer?**

According to the forecasts we published recently, yes, it will. Both in Spain and the euro area we are projecting a slowdown in the second part of this year. But, on average, for 2023 we are expecting 2.3 per cent growth in Spanish GDP, compared with the ECB's 0.7 per cent projection for the euro area. For 2024, 1 per cent growth is expected in the euro area, compared with 1.8 per cent for Spain. In 2025 it is 1.5 per cent for the euro area and 2 per cent for Spain. What explains this better performance? Employment growth is expected to remain positive, although at a lower pace, and this, together with the recovery in real wages, boosts households' income. A key difference from the euro area is that the pick-up in real wages is taking place with lower growth in both nominal wages and prices. As a result, export competitiveness is doing well. Also, the energy shock has had a less severe impact on Spain, given its lower dependence on Russia. As a result, manufacturing activity in energy-intensive sectors is doing comparatively much better. Finally, there is still some – albeit limited – scope for further recovery in tourism. Of course, monetary policy will be a drag on the Spanish economy, and in our case the effect is quicker because around 70 per

cent of our mortgages are still at floating rates. But the net effect of these factors is that Spain is expected to grow faster than the euro area. Although, of course, we have to keep emphasising that these growth projections for both the euro area and Spain are shrouded in great uncertainty, and with the balance of risks tilted to the downside in both cases. And, more importantly, with a medium to long run perspective one of the most important challenges of the Spanish economy is to converge towards euro area per capita income levels, which will require improving both productivity and employment dynamics.

**There is a debate in Spain about people switching from temporary contracts to so-called intermittent contracts. They are often not working and are looking for jobs but they don't count as unemployed because they still have a contract. How big a role has this had in reducing the jobless rate?**

It has certainly played a part. But even if you control for these factors, employment has performed positively. In 2021 Parliament approved a new labour market reform. The main objective was to reduce the share of temporary contracts in the economy, and that goal has been achieved and the switch to these intermittent contracts is only part of the explanation. The share of temporary contracts has fallen from 30 per cent to less than 20 per cent and the shift to intermittent contracts explains about one-quarter of that reduction. Then there is the debate about the positive impact of these workers keeping their relationships with their companies. For example, some of these workers may work only in the summer, but their contractual relationships continue throughout the winter. This is different from simply being fired and then being rehired, probably by another firm, and then being fired again, etc. So it seems reasonable to think that these workers may feel a bit more secure. And in any case, the other three-quarters of the reduction in the share of temporary contracts is due to "proper" permanent contracts (two of those quarters due to full-time contracts and the third to part-time contracts), and workers with those contracts definitely feel more secure about their jobs. In this regard, research published by the Banco de España last year shows that these conversions from temporary to permanent contracts may have contributed to the recovery in consumption. People with permanent contracts have lower saving ratios, because they feel more secure and they tend to consume more. In any case, any thorough assessment of this reform will require analysis of its impact on other variables, such as employment, unemployment, wages or productivity. For this, more time is needed.

**There's a growing concern that climate change and extreme weather events could lead to more supply side disruption of food production in key areas that could push up inflation. Do you think this is right?**

At the Banco de España we have also done some research on this. The most robust outcome of this analysis is that climate change might increase inflation volatility. This is important when analysing the dynamics of inflation for monetary policy purposes. As for the policies to combat climate change and promote energy transition, they might increase inflation, but mainly in the short to medium run. In the medium to long term they might even be deflationary. Let me give you just one example: the cost of producing one unit of energy with renewables, once you have developed that capacity, is much lower than the cost of producing it with fossil fuels. In any event, the impact on inflation will also very much depend on the policy instrument used to promote the production of renewable energy. If it is done via taxes then of course it will initially lead to an increase in prices.

**There is a lot of political uncertainty in Spain. What are the potential implications for economic policy?**

In today's world political fragmentation is common in many countries. Some have a tradition of such fragmentation and have managed to deal with it. For others, like Spain, this phenomenon is newer and we need to adapt. More important, in my view, is the clear need in Spain for structural reforms in different domains in order to increase productivity and reduce the unemployment rate, the structural fiscal deficit and the debt-to-GDP ratio. For these structural reforms and the fiscal consolidation process to succeed, the policy measures need to be of a permanent nature. Thus, it is essential that the design, approval and implementation of these measures are all backed by strong political consensus. Fiscal consolidation should get under way in 2024 and be framed in a detailed multi-year programme, thus ensuring its credibility from the outset and increasing the likelihood of a gradual consolidation process.

**Do you worry about the recent sell-off in bond markets?**

In my view, the recent increase in long-term interest rates is not related to domestic factors, such as changes in market expectations for euro area inflation. Rather, it has been driven by US market dynamics, and mainly by an increase in term premia, and passed through to other international markets due to the dominance of US bond markets. In any event, it has ultimately led to a significant increase in real rates in the euro area, particularly at the long end of the yield curve. The implications may differ from when rates are driven up by, for example, the market suggesting that euro area inflation may be more persistent. This is not the case now.

**What does it mean for monetary policy? Does it mean that you're even less likely to raise rates again at the ECB?**

Allow me to recall our September meeting at the ECB and our communication back then. Based on the information available to us, our models and our own judgement, we said that keeping the current level of rates for a sufficiently long period will be broadly consistent with achieving our 2 per cent inflation target in the medium term. What has happened since then? The incoming inflation data have basically confirmed our expectations for headline and, more importantly, underlying inflation. We have seen real yields rise, long-run inflation expectations decline and stock prices fall. Thus we have observed an additional tightening of financial conditions. And the latest data are indicating weaker growth. Indeed, based on our now-casting models, we cannot fully rule out slightly negative growth in the third quarter, which would be a mildly negative surprise as compared to staff projections. And the new war in the Middle East will certainly not help boost confidence, consumption or investment. So I think our September assessment for our monetary policy going forward is even more valid today. In any event, we should continue to emphasise that uncertainty remains very high, while following a data-dependent approach and remaining fully committed to meeting our target.

**What about the ECB balance sheet? Some members of the governing council are calling for an earlier end than planned reinvestments in the Pandemic Emergency Purchase Programme. Does what has happened in bond markets change that?**

I think caution is in order. There is a connection between increasing rates and reducing the balance sheet. We decided to use rates as the main instrument for setting our monetary policy stance. In parallel, we are also reducing our balance sheet, which complements our monetary policy tightening. And our September assessment is based on the combination of both instruments. Indeed, the ECB has reduced its balance sheet far more robustly than other central banks. If at any point we discuss changing the current path of balance sheet reduction, we will have to assess the degree of tightening provided by the combination of these two tools and to what extent such action would be compatible with reaching the inflation target in the medium term. Including of course the fact that, as I have said, financial conditions have tightened further over the last weeks. In other words, we have to be consistent with our framework. And then there is the important issue of PEPP reinvestments standing as the first line of defence against potential fragmentation in the transmission of our monetary policy. Admittedly, over the last year or so such fragmentation has been very limited. But we can't exactly say how much this owes precisely to the PEPP's dual role, including its role as the first line of defence against fragmentation. In addition, the slower growth setting and the additional tightening imported from the US has to be factored in. So having this first line of defence is to be welcomed. A further dimension of balance sheet policy that is coming into ever sharper relief is liquidity provision. This is being studied as part of the ongoing operational framework review. But it's certainly important in terms of setting the PEPP discussion in the right perspective. In any event, all this is also a reminder that reducing fiscal deficits and debt has to be taken seriously.